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BACKGROUND ON THE TAXATION OF LIFE INSURANCE COMPANIES AND THEIR PRODUCTS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled hearings on the Federal income tax treatment of life insurance companies and products for May 10 and 11, 1983. This hearing is necessitated by the expiration of certain temporary tax provisions affecting life insurance companies at the end of 1983.

Prior congressional action

The present law tax treatment of life insurance companies is based on the Life Insurance Company Income Tax Act of 1959. Prior to the 1959 Act, life insurance companies were taxed only on their net investment income in excess of amounts needed to fund obligations to policyholders. Thus, underwriting income (for example, the profit on term insurance contracts) was not subject to the income tax. The decline in interest rates during the period following World War II in conjunction with the investment income tax method eroded the income tax base to the point that the life insurance industry paid virtually no tax in 1947 and 1948. The Congress responded by enacting a series of three different temporary life insurance tax acts. In 1954, the Congress began the process of designing permanent legislation which culminated in the 1959 Act. The length of that legislative process is generally attributed to the difficulty of finding an acceptable balance of the tax burdens on various segments of the industry.

The 1959 Act adopted a bifurcated approach to the taxation of life insurance companies. As a general proposition, the 1959 Act taxes life insurance companies on their total income after deducting policyholder dividends; however, to preserve the prior law investment income tax-base of mutual companies, important limitations were placed on the deductibility of policyholder dividends. In addition, stock life insurance companies were permitted to defer tax on a portion of underwriting income unless it was distributed to shareholders. Other elements of the 1959 Act, which also contributed to adjusting the balance of tax burdens among various industry segments, included a small company deduction and special deductions for nonparticipating contracts and for accident and health insurance and group life insurance contracts.

The 1959 Act generally functioned as intended until interest rates (and hence earnings rates) increased significantly in the 1970's. High interest rates spawned a number of significant changes in the tax picture of life insurance companies. First, the limitation on deductions for policyholder dividends (being earnings rate sensitive) resulted in an increasing percentage of those dividends being nondeductible. Second, companies (especially mutuals) entered into increased volumes of modified coinsurance ("Modco") in an effort to reduce their Federal income tax by recharacterizing

investment income as underwriting income and avoiding the declining allowance for dividend deductibility. In 1981, one of the largest mutual companies used modified coinsurance to reduce its tax to zero. Third, some stock companies began to offer investment-oriented products that, in effect, allowed them to distribute currently high investment yields tax-free to policyholders. Mutual companies were slower in entering this market because their ability to pay policyholder dividends already permitted them to pass favorable investment experience through to policyholders although some of those dividends were taxed at the company level because of the limitation on the policyholder dividend deduction.

In 1982, the Congress responded to these changes in the life insurance industry through a number of tax changes including a permanent repeal of the provisions for the special tax treatment of modified coinsurance. The repeal of Modco was estimated to increase revenues by $2.3 billion in 1982 over an estimated prior law tax burden of $1.7 billion. Concern over the effect of so substantial a change in tax burdens led to enactment of a series of temporary provisions which generally had the effect of reducing the industry tax burden by an estimated $1.2 billion for 1982 and by the same amount for 1983. These provisions will expire at the end of 1983.

Summary of contents

This pamphlet provides information that may be useful in this undertaking and attempts to identify the major issues relating to the taxation of life insurance companies and their products, both from a general viewpoint and from the perspective of the 1959 Act. The first part of the pamphlet analyzes the various major issues by suggesting first that the design of life insurance tax provisions must begin with the tax treatment of policyholders. Historically, policyholders have not been taxed on life insurance investments unless, prior to death, they withdraw an amount in excess of the aggregate premiums paid. The application of this treatment to modern, investment-oriented contracts has been widely questioned. Indeed, the 1982 changes placed some limitations on investment-oriented products (see Part IV. c.). This pamphlet further suggests that the design of a corporate tax on life insurance companies requires the adoption of a theory of life insurance companies and of the nature of their contractual obligations so as to account for their economic, and taxable, income. For example, companies could be viewed as selling a single integrated line of insurance products, or as marketing insurance protection on the one hand and investment arrangements on the other. Similarly, one could adopt the view of the 1959 Act that mutual companies should be treated as nonprofit enterprises or one could treat mutual companies, to some extent, as profit-making enterprises owned by their policyholders.

The second part of this pamphlet provides information with respect to insurance products and their tax treatment. There is an analysis of the economic components of life insurance policies, a description of the leading products offered by life insurance companies, and a discussion of the tax treatment of life insurance products.

The third part describes the State regulation of life insurance companies and the various accounting rules applicable to life insur-

ance companies for State regulatory, Federal securities law, and Federal income tax purposes.

The fourth part describes the present law tax treatment of life insurance companies, including the origins of that treatment and the 1982 provisions. In the detailed discussion of present law, an attempt is made to identify some of the major issues suggested by present law. These include (1) the need to define insurance for tax purposes, (2) the correct measure of company liabilities to policyholders (including the revaluation of reserves), (3) the treatment of policyholder dividends, (4) the role of special deductions for nonparticipating contracts and accident and health insurance and group life insurance contracts, and (5) the deferral of tax on a portion of underwriting income. There is also a discussion of the tax treatment of foreign source income and of foreign companies operating in the United States or insuring U.S. risks.

The fifth part presents statistical information on life insurance companies and their tax burdens. Finally, an appendix provides a Glossary of life insurance-related terms.

I. TAXATION OF LIFE INSURANCE PRODUCTS AND COMPANIES—CONCEPTS AND APPROACHES

In designing legislation that appropriately taxes both life insurance companies and their products, full consideration should be given to the interrelationship that is established between the policyholder and the life insurance company in a life insurance transaction. Thus, it is helpful to begin by focusing on the tax treatment of policyholders and to keep that treatment in mind in designing provisions for the taxation of companies.

A. Tax Treatment of Policyholders

Historically, life insurance products have offered policyholders two benefits—insurance protection and a savings element—that have been combined in the product. For example, under whole life insurance, the buildup of cash value through overcharges of premiums in the early years of the policy together with credited earnings contributes generally to the reduction of the overall insurance costs in later years of the policy. This inside buildup traditionally has not been taxed to the policyholder unless the contract is surrendered prior to maturity, and then, only to the extent the cash surrender value exceeds the aggregate premiums and other consideration paid. One reason for this treatment might be that before a taxpayer may enjoy this build-up he must surrender a valuable right, the right to future insurance protection at a guaranteed cost. Recently, this characteristic of tax deferral has been emphasized and marketed as a way to shelter income from tax. Also, products have been designed to offer savings rates that are competitive with other financial institutions, in a general effort to attract taxpayer's savings dollar, as well as to encourage the use of such savings to purchase and reduce the cost of insurance. Against this background, the question that must be addressed in approaching policyholder taxation is: to what extent should taxpayers, as owners of insurance products, be allowed to defer taxation on current investment earnings or use before-tax investment earnings to reduce the cost of their insurance protection?

One answer to that question may be to allow an unlimited amount of such deferral or use. This policy would be justified by comparing the life insurance investment of a taxpayer to his other major long-term investments which typically include his home and his retirement savings. The Congress has generally adopted mechanisms through which the inside build-up of value with respect to housing and retirement savings may escape current tax. It could, therefore, be seen as logical to provide the same treatment for life insurance accumulations. In addition, the social benefits derived by the nation from having its population adequately insured and by the long-term investments made by insurance companies might

further justify deferral of tax on the inside build-up. A contrary approach would be to analogize the savings element of an insurance contract to bank savings. In such a comparison, would one conclude, for example, that interest paid on a savings account should be tax-free as long as that interest is irrevocably pledged and used to purchase term life insurance protection? On the other hand, the comparison of the savings element in insurance with a passbook account or certificate of deposit may lead one to conclude the opposite: that the entire inside build-up should be taxed currently. Thus, this raises the question of what investments should be used for comparison in deciding what is the proper tax treatment of life insurance products.

A second answer to the question may be to limit the amount of tax-deferral or before tax use of investment earnings. For example, investment earnings credited to certain insurance products might continue to enjoy tax-deferral up to a defined level or rate. Any current earnings in excess of that rate would be taxed currently. The rate chosen could reflect a judgment of what tax-deferral benefit has been historically allowed before the recent extraordinary rise in investment earnings rates. This would allow companies to continue to market certain traditional low-yield insurance products. At the same time, if a product is designed to give the policyholder the benefit of higher investment earnings through the distributions of policyholder dividends, interest in excess of that guaranteed for the life of the contract, or premium adjustments, then there would be some tax on the current earnings on the policyholder's investment in the life insurance product. Depending upon the type of product, companies might or might not be able to continue to market some of their tax-oriented investments.

A third answer may be to limit the amount of savings a taxpayer can invest in a life insurance product to obtain the benefits of tax-deferral and before-tax use of investment earnings. This might require limits and penalties similar to those used in retirement plans. Or, if one considers that a policy decision has already been made as part of the pension provisions, the amount of savings that can be set aside for tax-free accumulation of earnings, with respect to life insurance products generally (both life insurance and annuities) might be allowed for use in pension plans.

Finally, as a fourth answer, tax-deferral and before-tax use of earnings combined with insurance might be allowed only for certain defined products. This would require decisions regarding what constitutes life insurance or an annuity, for tax purposes. Should a minimum amount of pure insurance risk be required at all times under the contract? Likewise, the size of the savings feature might be restricted; for example, to qualify as a life insurance product that enjoys unique tax benefits, the cash value of the contract might be required to follow a pattern of certain traditional or "garden variety" insurance products that have not been heavily investment oriented.

Under current law, it might be said that policyholders have generally enjoyed an unlimited tax-deferral or before-tax use of investment earnings under life insurance products. However, an examination of the interrelationship of policyholders and life insurance

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company taxation shows that existing law may already contain the seeds of the various approaches described above.

The ability of the policyholder to achieve tax-free accumulation of cash value has been reflected in the taxation of life insurance companies. Companies have been permitted, in computing their taxable income, to claim deductions or exclusions for the policyholders' share of company investment income. The general effect of such a deduction is to shelter income which contributes to the policyholders' cash value from tax at the company level, allowing full tax-deferral or before-tax use of such income. The absence of such deductions, or any limitation on deductions for distribution of investment income to policyholders, would result in substituting a corporate tax for an individual tax on increases in cash value. The present limitation on the company deduction for policyholder dividends may be viewed as having this effect.

Likewise, the temporary guidelines for flexible premium life insurance could be viewed as a response by Congress to the recent trend of marketing life insurance products as shelters for increased investment earnings. Limitations were placed on products like universal life insurance, requiring that a minimum amount of insurance protection must co-exist with the policyholder's cash value investment. A similar response to marketing trends also can be seen in the current provisions for taxing annuity contracts. A 5-percent penalty on distributions made within 10 years of a contribution to a deferred annuity and the cash withdrawals rules might be viewed as being patterned after rules for IRAs and Keoghs. The effect of these provisions is to restrict tax-deferral to certain qualifying products or to limit tax-free accumulation of investment earnings to certain products used for long-term savings. These provisions, however, do not alter the tax treatment of these products for the companies.

B. Tax Treatment of Companies

The taxation of life insurance companies has evolved in a manner consistent with the treatment of policyholders. The earliest life insurance company tax provisions taxed the "free" investment income of life insurance companies at the corporate rate. Free investment income is the amount of the net investment income of the company which is treated as not necessary for meeting obligations to policyholders. The measure of the company's obligations to policyholders varied from a fixed percentage yield on reserves to more complex formulas. The theoretical justification for taxing only free investment income was that the annual determination and taxing of underwriting income would be inaccurate given the long-term character of life insurance products. However, the 1959 Act responded to a concern that prior law had failed to tax income from profitable underwriting activities of certain stock life insurance companies. Thus, under the 1959 Act, both investment income and income attributable to favorable mortality and expense experience (i.e., the underwriting income) were subjected to taxation.

Accepting the policy decision to tax all the income of life insurance companies, one is faced with the unique problem of an ex-

traordinarily competitive industry that is made up of both profit and nonprofit organizations for which the market share of the business is split more or less evenly.[1] Given this fact, an important question to be answered is which organization should be used as the model for the company taxation—the stock company or the mutual company? Also, what competitive balance should be recognized by the tax law?

The 1959 Act answered these questions and resolved the tension between these two industry segments in several ways. It taxed both stocks and mutuals on their free investment income unless it was offset by underwriting losses. With respect to underwriting income, it adopted the nonprofit mutual company as its model, allowing a tax-free distribution of underwriting profits to policyholders through a deduction for policyholder dividends. To achieve a certain competitive balance within the industry, it reduced the gain from operations tax base for stock companies by allowing certain special deductions for nonparticipating contracts, and accident and health insurance and group life insurance contracts, and by deferring the tax on one-half of their underwriting gains.

An alternative approach for designing life insurance company tax legislation in answer the questions stated earlier would be to use the stock company as the model for company taxation and achieve any desired competitive balance by requiring mutual companies to recognize a minimum underwriting profit to be taxed at the corporate level. Adoption of this approach might be based on the view that the business of life insurance is so essentially a commercial activity that nonprofit organizations should not be allowed to engage in it without recognition of some minimum tax liability. The adoption of this tax policy view might be compared with that which prompted the adoption of the unrelated business taxable income provisions for tax-exempt organizations and contrasted with the treatment accorded mutual savings banks and nonlife mutual insurance companies.

A third, and entirely different approach to the company taxation problems, may be suggested by the State law taxation. That is, a premium tax could be imposed in lieu of an income tax, with respect to all or a portion of the current income tax base. For example, free investment income could be taxed to all companies and a net premium tax imposed in lieu of the tax on underwriting income.

The use of reserve accounting.—After deciding what taxpayer model should be used in designing life insurance company taxation, the question of how taxable income should be computed must be faced. Given the dual elements of insurance protection and savings that may be purchased by the premium dollar, the question arises as to whether the entire premium dollar should be treated as gross income. If the savings element of the premium is viewed as similar to a deposit in a bank, it may not be appropriate to include it in income. However, if that portion of a premium not required for current insurance protection is viewed as a current overcharge to

[1] The market share of the life insurance business is split more or less evenly between stock companies and mutual companies, although in number of companies, the stocks outnumber the mutuals more than 9 to 1.

defray increased costs in later years, arguably, the company's liability for future benefits giving rise to these costs should be recognized currently in order to properly match income and expense. This type of income analysis gives rise to a reserve method of accounting. Under any framework for taxing life insurance companies that recognizes reserve accounting to measure and currently accrue future liabilities, the question of how those reserves are computed is very important.

As a reserve or recognition of a future liability, the amount taken into account currently should be discounted and reduced by any further premiums or consideration expected in the future (also discounted). Traditionally, life insurance reserves have been discounted by both interest and a mortality factor. As the actual liability approaches in time, the reserve increases, with such increases generally offsetting income of the company. If one views the reserve as an actual fund that must be set aside to meet the policy liabilities, then the increase in an insurance reserve over the course of a year will be due to a combination of premium overcharges and earnings credited.

As is discussed in section III.A., of this pamphlet, if a company uses conservative assumptions for interest and mortality, the initial reserve must be higher (i.e., more "premium contributions" must be set aside initially) to grow at a conservative interest rate to the maturity value of the contract. Such conservative assumptions may not be economically realistic, or even recognized by the company for purposes of pricing its product. For tax purposes, then, the use of conservative assumptions in computing reserves may have the practical effect of accelerating deductions for the company, causing a mismatching of income and expense in a way opposite to that which would have resulted if reserve accounting were not allowed.

In computing investment income and gain from operations under the 1959 Act, the deductions for reserves are essentially equal to the amount required to be added to reserves under State law. As noted earlier, a deduction for earnings required to be credited to reserves can have the effect of sheltering and ensuring tax deferral for policyholder investment earnings. Likewise, conservative assumptions in computing reserves can have the effect of sheltering company surplus from Federal income taxation by accelerating deductions for reserve liabilities.

A tax base that reflects both company and product taxation.—As was stated early in this discussion, an understanding of the interrelationship of the policyholder and the company within the life insurance industry can be the basis of the legislative approach adopted for the taxation of both the company and the product. A structure for taxation at the company level can recognize this interrelationship and combine the company model adopted and the desired tax treatment of the policyholder. For example, such a tax structure might recognize that a policyholder has dual roles, as a consumer and an investor. In order to allow a certain level of tax-free accumulation of earnings within an insurance product, a policyholder's share of investment earnings could be excluded from the company's income tax base. The remaining investment earnings accruing to the benefit of policyholders (either as earnings credited to

contracts or as actual distributions) would be considered income accruing to policyholders as investors but taxes at the company level at a corporate rate that is derived from individual tax rates.

Depending upon whether a mutual company or stock company model is adopted, one would have to consider whether some portion of the investment income accruing to policyholders of a mutual company should be treated as income accruing to them as equity owners of the company (in which case a corporate rate of tax might be appropriate). Underwriting income that is distributed to policyholders could be viewed as a return of premium overcharges without tax at the company level. But once again, should some portion of such a distribution within a mutual company be treated as a distribution of owner profits that should be taxed at the company level? This combined approach to company and policyholder taxation may suggest a separation of underwriting and investment income for tax purposes in order to maintain the integrity of the dual policyholder roles, so that investment earnings that benefit the policyholder cannot be distributed, with tax at the company level, as a return or reduction of premium charges.

C. Major Issues Suggested by the Various Approaches

Treatment of policyholders

A convenient starting point for the design of a tax system to apply to life insurance companies and products is the treatment of policyholders. If the present law treatment of products is to continue, then no change in the direct treatment of the policyholder is necessary. Similarly, companies could continue to be given adequate deductions for policy obligations in order to avoid a "hidden" tax at the company level.

If the tax advantages related to insurance products are to be limited, then some additional problems may arise. If a portion of the policyholder share which is not taxed under present law is to be subjected to tax, then it must be decided whether the tax should be collected at the policyholder or at the company level. If a tax is to be imposed directly on policyholders, appropriate measures to assure compliance must be designed. The adoption of a company tax, either as a minimum tax on free investment income or as a tax in lieu of a policyholder tax, raises the additional question of what would be an appropriate tax.

Life insurance companies

Designing a corporate level tax requires adoption of a theory of life insurance transactions. Should company activities be viewed as the provision of an integrated line of services and products subject to a unified tax system or as the marketing of insurance products on the one hand and investment products on the other hand with the two businesses being subject to a bifurcated tax system? Each theory suggests different resolution of various issues. For example, the unified approach suggests that policyholder dividends should be viewed largely as price adjustments that reduce company income while the bifurcated view suggests that policyholder dividends are largely returns on investments which should be taxed to the company or policyholder.

Under either approach, the method of computing the policyholders' share of company income is of central importance. If companies are viewed on an integrated basis, it may be appropriate to define this share not on the basis of State law requirements but instead on the needs of the company as suggested by their experience. If, under a bifurcated approach, a lower rate of tax is imposed on the policyholders' share of company income, then correct computation of that share will have direct revenue consequences. It could be argued that since at any given time the cash surrender value of a policy will closely approximate the reserve as computed under State regulations, State reserves are an adequate measure of an insurer's liability on a contract. In addition, departure from a State law definition of the policyholders' share may cause significant administrative complexity. Also it may be criticized as an attempt to impose Federal regulation of the industry by making a judgment as to the economic adequacy of reserves.

Also, whatever approach is adopted for the taxation of life insurance companies and their products, the question of scope of application can arise. Present law limits the rules relating to life insurance company taxation to companies satisfying a statutory definition of life insurance companies. The tax rules applicable to life insurance companies can differ significantly from those applicable to nonlife companies. Should any changes made in taxation of life insurance companies be applied to all companies to the extent they have income from the sale of life insurance products?

Finally, if the growth of investment-oriented insurance products is limited by defining what is a qualified insurance product, it will be necessary to decide whether that definition applies only with respect to the treatment of policyholders or also to the treatment of the company. For example, will companies be permitted the same types of deduction for obligations to policyholders on nonqualifying and qualifying products? If a company sells predominantly nonqualifying products, should it nonetheless be treated as a life insurance company for tax purposes?

II. LIFE INSURANCE PRODUCTS AND THEIR TAXATION

A. Economics of Life Insurance Policies

The purchase of a traditional whole life insurance contract can be thought of as two separate transactions or as consisting of two separate elements. The first is the purchase of pure term insurance and the second is an investment in a type of savings plan. This concept can be understood by looking first at a policy that is primarily pure insurance, and secondly at two sample policies that provide for savings.

Policy 1

Under a 10-year term insurance policy, if specified annual premiums are paid, a company agrees to pay the beneficiary, $1,000 if the insured who is 40 years old when the policy is issued, dies at any time within 10 years. There is no maturity value, no cash-surrender values, and no insurance after the 10 years. To determine what the premium must be, the company considers a group of such policies all issued in the same year to men of the same age. Assume that a mortality table indicates that an average of 5 out of 1,000 persons of the group will die each year. To insure a group of 1,000, and assuming the company does not intend to invest the premium payments, the insurance company would have to obtain $5 per man per year to pay $1,0000 for each death. This is called the net premium. The company will also have to pay agents' commissions, and administrative expenses. If this amounts to $4,500 for the 1,000 policies during the 10 years, an additional $0.45 per policy will be needed. The actual $5.45 charged is the gross premium, $5.00 for the net premium, and the extra $0.45 is the loading factor.

Actual mortality may be less than the expected mortality; only 3 instead of 5 may die in the first year, 4 in the second and third, so that the company may pay $3,000, $4,000, and $4,000 in death benefits instead of the indicated $5,000 each year. The differences of $2,000, $1,000, and $1,000 make up income to the company called mortality savings or mortality gains. There could also be mortality losses. The expenses of the policies could, of course, be greater or less than $4,500 giving rise to additional income or loss. The combination of gains and losses from mortality and from loading may be called underwriting income (or loss).

Policy 2

Under a 10-year endowment policy, if specified annual premiums are paid, a company agrees to pay the beneficiary $1,000 if the insured dies within 10 years (as with the 10-year term policy) and also agrees to pay the insured $1,000 at the end of 10 years, or to pay lesser sums upon surrender before that time. With 1,000 such

policies the company must pay, instead of an indicated $100,000 because of deaths, $1 million if all survivors retain their policies. The net premium, instead of being $5 per year, is therefore slightly less than $78, if a 5-percent interest rate is used.

Since $78 instead of $5 is the net premium, while only $5 (on average) will be needed for death claims the first year, it is clear that the additional $73 is an amount which is put aside as savings for the insured in that year. This, and the savings elements is subsequent premiums, are payments made to obtain $1,000 at the end of 10 years. In order to pay the insured that $1,000, the insurance company must invest these annual savings elements and repay them with a considerable amount of interest added, at the maturity of the policy.

The actual premium charged for such a policy may include a loading factor that is higher than in the term policy, for example $8.50 for commissions and expenses, making a gross premium of $86.50. As with term insurance, there may be income or loss from the loading or from the mortality experience. There is another element of considerable importance in this policy, however, the difference between actual interest earnings and the rate of 5 percent assumed in computing the net premium. If the actual earnings rate were 7 percent the company would have extra funds, similar to those available when actual mortality is less than the expected mortality from the table.

Policy 3

Although it is not so apparent as with an endowment policy, there is a substantial savings element in the "ordinary" level premium whole life policy. For such a policy, assuming the premiums are paid up after 10 years, the net premium may be $31 as compared with $5 for the term policy and $78 for the 10-year endowment policy. But since, as with the others, only $5 (on average) is needed to cover indicated deaths the first year, the excess of $26 represents a savings factor analogous to the $73 from the endowment-policy premium. This, and similar excess amounts from subsequent premiums, are in effect savings of the policyholder left with the company at interest.

It is frequently said that, with such a level premium whole life policy, the excess premium paid in the early years offset the deficiency in premiums (because of increasing mortality rates) in the later years. Perhaps a better statement is that the excess premiums of the early years build up a savings element which, as it increases, reduces the insurance element (i.e., the net amount at risk for the company). When the policyholder reaches age 60 the indicated average mortality may be 20 to 1,000 instead of 5 to 1,000. For term life insurance of $1,000 the net premium would thus be $20 (without any discount for interest). But by that time the reserve, or savings element for the whole life policy, might be $450. Thus, the insurance element would be so reduced that, for every death only $11 from each of 10 policyholders need be collected to meet that obligation.

The aggregation of these savings elements from all premiums, plus the interest previously accumulated, make up the bulk of the reserves of any typical life insurance company.

B. Role of Life Insurance Products as Protection and Investment

In the past few years, the range of financial products into which individual investors can place their savings has expanded significantly. At the same time, through mergers and expansion across financial markets, the competitive structure of financial intermediaries has virtually eliminated the distinctive characteristics of the financial industry's industrial compartments. Insurance companies now combine savings instruments with life insurance, while, for example, various forms of insurance, real estate brokerage and securities brokerage are available through subsidiaries of a major nationwide retail establishment.

The variety of life insurance industry products continues to reflect two characteristics—life insurance protection and savings with earnings subject to tax deferral. The broader competitive plane on which life insurance companies, as financial intermediaries, now operate reflects both deregulation of parts of the industry and unusually high rates of interest during peak inflationary years during which investors moved their funds rapidly among alternative, high-yield and frequently short-term debt obligations. Insurance policyholders used policy loan rights and the cash value of insurance products to transfer funds from low-yield insurance policies to higher yield instruments, such as, money market funds and Treasury bills. In what might be characterized as self-defense, insurance companies inventively constructed insurance-savings combinations that could compete in the money markets.

Traditional role of life insurance products

The traditional concept of insurance has been to protect the insured against a loss that would require a substantial cash payment or would reduce or deprive a family of its income source. Life insurance and other forms of insurance were not considered as forms of investment nor as component parts of a financial portfolio.

In this role life insurance products have traditionally been of four major types. These are term insurance, whole life insurance, endowment insurance, and fixed annuities.[1]

Term insurance

Term insurance is a contract that furnishes life insurance protection for a limited number of years, the face value of the policy being payable only if death occurs during the stipulated term, and nothing being paid in case of survival. Such contracts may be issued for a period as short as one year, or may provide protection for the life expectancy of an individual with premiums being level throughout the period. Although these contracts are strictly protection contracts, the leveling of a premium over a long period of years produces a small cash value that increases to a point and then declines to zero at the termination of the contract.

In most term contracts, the face amount of the policy remains unchanged during the period of protection. However, the face amount may decline year by year from a given initial amount of

[1] Noncancellable accident and health insurance, because of long-term nature of the rate commitments, might also be considered a traditional life insurance product despite the fact that it is casualty insurance.

insurance to zero (or increase from an initial amount to some higher amount) at the end of the term of the contract; this is known as "decreasing" or "increasing" term insurance.

In a yearly renewable term contract, the insurance element is the face amount of the policy and there is no investment element. In a term-for-years contract with level premiums, the insurance element is the difference between the face amount and the cash value. The investment portion of this contract is the cash value that accumulates at interest to be liquidated to support increased insurance costs during the later part of the term.

Whole life insurance

A whole life insurance contract provides for the payment of the face value upon death of the insured, regardless of when it may occur. Such protection may be purchased under either of two principal types of contract, the chief difference between the two being the method of payment: (1) an ordinary life contract, or (2) a limited-payment life contract.

The ordinary life contract assumes that premiums will be paid throughout the insured's lifetime. In the early years, the annual level premium is in excess of the amount required to pay the current cost of the insurance protection. The balance that is retained by the company as a reserve, at interest, creates a cash value which reduces the insurance risk in later years when the annual level premium would no longer be sufficient to cover the annual cost of insurance in the face amount. The cash value accumulation continues until reaching the face value of the policy at maturity (typically age 100).

Under the limited-payment life contract, the face of the policy is not payable until death, but premiums are charged for a limited number of years only, after which the policy becomes paid up for its full amount. The premium under such a contract will be significantly larger than the aggregate amount paid during the same period under an ordinary life contract so that the company can carry the policy to maturity without further charges. The extreme case is the single premium whole-life policy. The insurance element in this type of policy is the difference between the face amount and the cash value. The cash value that accumulates at interest to maturity of the contract is the investment element in the policy. This savings or investment feature is characteristic of all permanent plans of insurance.

Endowment contracts

An endowment insurance contract provides not only for the payment of the face amount upon the death of the insured during a fixed term of years, but also the payment of the full face amount at the end of the term if the insured is living.

Under an economic analysis, such a contract can be viewed as decreasing term insurance and an increasing investment. The investment portion of the contract, which is the cash value that accumulates at interest, is available to the insured at any time after the first couple of years through surrender or a loan upon the policy. At any time, the sum of the accumulated savings fund and the decreasing term insurance will always equal the face of the contract.

The decreasing term policy, the insurance element, may be viewed as that portion of the policy that the policyholder intended to save if he had lived, but that was not saved because of premature death.

Under a mathematical analysis, such a contract can be viewed as level term insurance and pure endowment. That is, endowment insurance is essentially a savings plan (to accumulate a specific sum over a period of time) with insurance to protect that plan against premature death.

Fixed annuities

In a fixed annuity contract the insurance company agrees, for a cash consideration (in single or multiple premiums), to make specified payments during a fixed period or for the duration of a designated life or lives. A deferred annuity is an annuity contract that has not reached its annuity starting date, when the periodic payout begins. It has two phases: an accumulation phase and a payout phase. An immediate annuity has only a payout phase.

Most annuity contracts contain a refund feature stated either in terms of a guaranteed number of annuity payments whether the annuitant lives or dies, or in terms of a refund of the purchase price (or some portion thereof) in the event of the annuitant's early death (prior to the annuity starting date).

When the number and amount of future annuity payments are based on a contingency (e.g., the life of the annuitant), the contract contains an insurance element. Prior to maturity, a deferred annuity contract is an investment contract for the accumulation of a principal sum to be applied to provide periodic payments after the annuity starting date. After the annuity starting date, payments may be a liquidation of the accumulation amount together with interest (fixed term annuity), or of the accumulation amount together with interest and mortality experience (life annuity).

The role of life insurance products as investment

Generally, the concept of a balanced investment portfolio requires a balancing of risks, current income (interest or dividends) and capital appreciation. The investor would mix assets so that the risks of loss of capital value or reduced income in some assets are offset by gains in others.

Recent approaches to financial analysis and investment portfolio management have considered various forms of insurance as portfolio assets that provide hedges against immediate cash requirements because of casualty or health reasons and deprivation of income. Under this analysis, insurance is considered as a hedge against certain income losses or a forced sale of assets. Annual premium payments thus become part of that year's savings, and even though the nominal value of the portfolio is not increased through the purchase of insurance, the long-term stability of the value of the portfolio is enhanced because of increased protection against liquidation of some assets that become mandatory because of nonportfolio losses.

With respect to life insurance, risk aversion would involve a relationship in which the amount of insurance needed (i.e., family protection) is related inversely to the age of the insured and the size and diversity of the remainder of the investment portfolio. Life in-

surance coverage beyond this requirement involves decisions about the size of the annual premium payment relative to the annual payment required to maintain the desired amount of insurance in effect and basic portfolio decisions about how to invest savings consistent with a desire for risk aversion. The desired amount of life insurance coverage diminishes as the insured person's age increases and children complete their education and become financially independent.

Many insurance products now also provide savings elements and tax deferrals that warrant consideration as portfolio investments. Life insurance premium payments that are greater than the amount necessary for insurance protection are savings and build up the cash value of the policy through interest accruals, which are not included in gross income. The resulting tax deferral is a valuable attribute and may allow a faster rate of compounding than possible with some taxable interest rates after payment of taxes.

Modern products

In recent years, a number of products have been developed which emphasize the deferral available through life insurance and annuity contracts. Unlike traditional contracts which guarantee small amounts of tax-free buildup over extended periods at fixed interest rates, these contracts have given investors access to deferral on relatively high yields over shorter periods. To a large extent, these new products arose from the need of stock companies to compete effectively with the traditional products of mutual companies who brought with them the ability to pay out high yields as policyholder dividends. For nonparticipating policies, additional tax-free buildup is being returned to the policyholder through mechanisms that allow for a larger cash values of the policy without any additional cost or through reduction of the current premium. Such mechanisms allow for the purchase of these benefits with before tax dollars.

Universal life

One of the new products which allows investors to obtain high yields on their investment while still receiving the treatment given to life insurance products is universal life insurance. Universal life is a flexible premium life insurance policy under which the policyholder may change the death benefit from time to time (with satisfactory evidences of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates which may change from time to time above a floor rate guaranteed in the contract.

The death benefit under such a contract, typically, may be one of two options: (1) a face amount or, if greater, the contract's cash value at the time of the insured's death plus a specified amount (a corridor of pure insurance protection); or (2) the contract's cash value at death plus a level specified amount (a corridor of pure insurance protection).

In a universal life policy, the investment element is the cash value that accumulates at interest, which interest may be adjusted

above a minimum guaranteed rate to reflect anticipated actual earnings of the company. The insurance element of the policy is the difference between the prescribed death benefit and the cash value.

Variable life

A variable life insurance policy is one under which the benefits relate to the value of assets behind the contract at the time the benefit is paid. The amount of death benefit payable, generally, is never less than the initial death benefit payable under the policy but otherwise varies with the unit value of the underlying investment account.

Similar to a variable annuity, premiums from variable life insurance purchase units in a segregated investment account managed by the insurance company. Variable life insurance is a security subject to the Securities Act of 1933.

Variable annuities

An annuity contract in which the amount of each periodic income payment may fluctuate is called a variable annuity. The fluctuation may be related to securities' market value, a cost of living index, or some other variable factor.

During the accumulation phase of such a contract, premiums are invested in a segregated investment account at a current unit value (similar to the purchase of units in a mutual fund). The cash value of the contract will fluctuate with the increase or decrease in unit value associated with the segregated investment account. At the annuity starting date, the accumulated total number of units credited to the contract is applied (according to actuarial principles and the current valuation of the unit) to convert the accumulation to income payments. Instead of providing for payments of a fixed number of dollars, the variable annuity provides for the payment each month or year of the current value of a fixed number of annuity units. Thus, the dollar amount of each payment depends on the dollar value of an annuity unit when the payment is made. Although the company may assume a mortality risk under a variable annuity for life, the annuitant assumes the entire investment risk. Variable annuities are securities subject to the Securities Act of 1933.

The underlying investment of such a contract can be viewed as any kind of a regulated investment company (mutual fund, money market fund, etc.) and, as with such other investment companies, the investment risk is borne by the contractholder. There is an insurance element associated with the actuarial computation of a variable annuity for life as with any life annuity.

C. Taxation of Products and Related Issues

Historically, the Federal tax laws have permitted a tax-free accumulation of amounts necessary to fund the insurance protection of life insurance products. Thus, companies have been allowed deductions for increases in reserves and policyholders have not been taxed on increases in cash values. Generally, distributions of cash value on surrender of a policy have been subject to income tax only

if they exceed the aggregate premiums and considerations paid, and death benefits have not been subject to income tax at all. (Under current law, consideration paid for the contract is not reduced by the cost of pure insurance consumed while the policy was in force.) Annuity contracts have also been permitted tax-free accumulations; however, these accumulations have been taxable when distributed.

Death benefits

Generally, amounts received under a life insurance contract by reason of the death of the insured are not subject to income taxation.[1] An exception to this rule applies in the case of the proceeds on flexible premium insurance contracts which fail to meet either of two statutory guidelines tests at any time during the duration of the policy. In such a case, the contract will be treated as providing a combination of term life insurance and an annuity or deposit fund (depending on the terms of the policy).

A flexible premium life insurance contract is a life insurance contract which provides for the payment of one or more premiums that are not fixed by the company as to both timing and amount. Thus, under such a contract, the insurance company may fix the timing of the premium payments but not the amount, the amount of the premiums but not the timing, or neither the timing nor the amount of the premiums.

The first guideline test provides that two requirements must be met at all times: (1) the sum of the premiums paid under the contract at any time cannot exceed a specifically computed guideline premium limitation; and (2) the amounts payable on the death of the insured cannot be less than a certain multiple of the contract's cash value as of the date of death. For purposes of applying the first requirement, the sum of the premiums paid includes premiums for any additional qualified benefits as well as the primary death benefit.

The premium limitation in the first test is intended to prevent investment motivated contributions of large cash amounts to the contract. The second requirement provides a restriction on the death benefits in order to insure that flexible premium contracts offer at least a minimum amount of pure insurance protection at all times.

The second alternative guideline is a specific cash value test patterned after a traditional whole life policy. That is death proceeds paid from a flexible premium life insurance contract will be excluded from the beneficiary's gross income if, by the terms of the contract, the cash value does not exceed at any time the net single premium for the amount payable by reason of the death of the insured (without regard to any qualified additional benefit) at such time.

Thus, present law directly addresses a central issue of defining life insurance from the perspective of the policyholder by requiring that a minimum pure insurance risk co-exist together with the savings feature of the contract.

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[1] Proceeds are subject to the estate tax, however, if the decedent possessed any incidence of ownership in the policy at his death.

Annuities

The taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income under an "exclusion ratio" computed to reflect the projected nontaxable return of investment in the contract and the taxable growth on the investment. Policy dividends paid after annuity payments begin are not subject to the "exclusion ratio," but are taxable in full to the policyholder as ordinary income. Before the Tax Equity and Responsibility Act of 1982, amounts paid out under a contract before the annuity payments began, such as payments upon partial surrender of a contract, were first treated as a return of the policyholder's capital and were taxable (as ordinary income) only after all of the policyholder's investment in the contract had been recovered.

Two changes were made by TEFRA to the tax treatment of annuity contracts.

The first change made by TEFRA is that partial surrenders or cash withdrawals prior to the annuity starting date are income to the extent that the cash value of the contract exceeds the investment in the contract. To the extent that such cash value does not exceed the investment in the contract, such withdrawals are a return of capital to the policyholder and reduce the taxpayer's investment in the contract.

Policyholder dividends received prior to the annuity starting date are cash withdrawals subject to the new rules. Such policyholder dividends are not included in the taxpayer's income to the extent they are retained by the insurer as premiums or other consideration paid for the contract.

The second change made by the Act is that a penalty is imposed on certain distributions from an annuity contract. The penalty is equal to 5 percent of the amount includible in income, to the extent the amount is allocable to an investment made within 10 years of the receipt of such amount. For this purpose, an amount includible in income is allocable to the earliest investment first. Also, because policyholder dividends received before the annuity starting date are cash withdrawals and includible in income to the extent there is income in the annuity contract available for distribution, such amounts are also subject to the 5 percent penalty to the extent the income in the contract is allocable to an investment within the last 10 years. Of course, if the policyholder dividend is retained by the company and reinvested in the contract, it is not includible in income and is not subject to the 5 percent penalty.

Some observers have contended that there are arbitrary elements in making the distinctions between taxable or nontaxable policyholder dividends. Whether paid out to the prospective annuitant or retained by the company, the policyholder dividend should be treated in the same manner in either case. As presently treated in the Code, a bias is created in favor of leaving the policyholder dividend with the company even though the dividend may reflect an overpayment of premium. If the dividend reflects excess earn-

ings, a case can be made for treating the dividend as taxable income.

Imposition of penalties may be made because of certain distributions from an annuity contract within a 10-year period. This also is an arbitrary period, and reasonable grounds may be presented for a shorter or longer period. Alternatively, the period during which the distribution is subject to penalty could be related to the age of the insured and the average period of mortality.

Certain amounts paid in connection with insurance contracts

With some exceptions, present law permits a policyholder to deduct interest payments made to life insurance companies on loans secured by the cash value of their insurance policies. A deduction is disallowed for interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract; or for any amount paid or accrued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium life insurance, endowment, or annuity contract) pursuant to a plan which contemplates the systematic borrowing of part or all of the increases in the cash value of such contract. This latter rule has a safe-harbor test which will allow a deduction for interest so paid provided certain requirements are met.

Legislative history indicates that the safe-harbor provisions were to provide for the retention of rights to borrow on insurance for other than tax-saving purposes without the loss of the interest deduction.[2] Recently, however, life insurance plans have been marketed not only for their tax-deferral characteristics, but by emphasizing the present tax benefits under maximum borrowing provisions. Although these plans literally fall within the safe-harbor rules, the borrowing encouraged under such plans could be viewed as solely tax-motivated. In light of such marketing activities the need for any safe-harbor rules arguably should be reexamined.

In addition, if one reasons that deferral of tax earnings within a life insurance contract should be allowed so that policyholder can save for the future or premature death, then arguably it would be inconsistent to let a policyholder borrow against the cash value of a contract at all. Such borrowing not only allows current use of the money tax free, but results in an interest deduction for interest paid. In light of certain tax policy decisions already adopted in the areas of retirement plans and annuities (which treat loans as cash distributions of income, to the extent there is income in the contract), it might be suggested that similar treatment be considered for life insurance policies.

Deductibility of premium payment

Present law treats premiums as income subject to taxation to a life insurance company. However, due to the non-taxable nature of death proceeds and the policyholders' share of investment income necessary to carry a contract, current law disallows a deduction for life insurance premiums paid.[3]

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[2] H.R. Rep. No. 88-749, 88th Cong., 1st Session (1963)

[3] Within certain confined limits, life insurance premiums may be taken as a business expense.

However, current law also provides that an employer may purchase $50,000 worth of group term life insurance for his employees and the cost of such insurance is not income to the employee. If more than $50,000 is purchased, the employee has income to the extent that such cost exceeds the cost of $50,000 of such insurance plus the amount paid by the employee toward the purchase of such insurance.

III. REGULATORY AND ACCOUNTING CONSIDERATIONS

A. State Regulation

1. History

State regulation of the life insurance industry dates back to the early 1800's mainly through the efforts of Elizur Wright, an abolitionsist who turned his crusade to life insurance after attending an English policy auction.[1] During the period 1828–1851, reporting requirements of the different States (mainly New York and Massachusetts) were generally in the nature of a questionnaire. Some of the reports attempted to create a form of balance sheet, but they were not uniform. Generally, these early forms did not show assets and liabilities in balance, primarily because insurance in force was included as a liability.

In 1859, Massachusetts required insurance companies to report reserves on the basis of net premium valuations and to disclose the assumptions used to determine the reserves (i.e., interest rates and mortality). In the same year, the New York Insurance Department was created. By 1871, fourteen of the thirty-seven States had enacted insurance legislation requiring all companies doing business in the State to file financial statements in the State. Most States had unique valuation standards and unique reporting requirements, thereby creating a lack of uniformity. By 1875, a standard "Convention" reporting blank was adopted for use in all States and standards of asset and reserve valuations were adopted. The statement adopted in 1875 remained basically unchanged until a revison took place in 1951. The 1951 revisions improved the format but left the substance of the prior Convention statement basically unchanged. Thus, many of the basic accounting methods used over a century ago are still in practice today for state regulatory purposes.

2. Modern regulation

The Convention Statement

The Convention Statement has changed little over the past 100 years because its purpose has not changed. The Convention or Annual Statement is used to show the solvency of the company.

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[1] In the early days of the life insurance industry, cash surrender values were rare. Old people who could no longer afford the premiums offered their policies for sale at an auction. People would bid on these policies speculating on how much longer the policyholder would live (and thus how much they should pay for the policy). The policyholder would actually mount a block where he was physically inspected. This reminded Elizur Wright so much of American slave auctions it aroused his evangelical wrath. Upon returning from England, he lobbied the Massachusetts legislature for insurance legislation including nonforfeiture laws and proper measurements of policy reserves to ensure solvency and was eventually appointed as one of a two-man board of insurance commissioners. (R. Mehr, *Life Insurance Theory and Practice*, 710 (1977).)

"Ultra-conservatism is built into the [balance sheet], apparently on the theory that if a company can show an excess of assets over liabilities and capital stock under the restrictions imposed, State officials may justificably assume that a company has sufficient resources to carry out the provisions of every policy in force." [2]

Because of this concern for solvency, the New York legislature commissioned the Armstrong investigation which reported poor management, trickery, deceit, and squandering of funds in the insurance industry. The New York Insurance Code of 1906 grew out of this investigation. Other States soon amended and strengthened their own codes using the New York code as an example. Today, every insurance company doing business in a State must file an Annual Statement. The Annual Statement which contains all of a company's financial statements calculated according to the State regulations and prescribed accounting methods, is considered an insurer's first line indicator of solvency.

The Annual Statement contains, among other items, a balance sheet, a summary of operations, a detailed description of reserves (both life and nonlife), a statement of changes in financial position, an analysis of operations by lines of business, examinations of premiums paid, dividends, and a myriad of other detailed schedules for such items as investment income, capital gains and losses, general expenses, and stocks, bonds, and securities held. Although the same general format is used by all States, the financial statements contained therein will vary from State to State. Some assets may be admitted in one State but not in another. Securities may be valued using different methods. Methods of valuing reserves and interest rate ceilings will vary. A major criticism of Annual Statements is that they are complicated and not easily understood, especially by the insured and investing public.

State vs. Federal regulation

There has been a long debate over whether insurance should be regulated at the State level or the Federal level. In 1866, a bill was introduced to create a national insurance bureau in the Treasury Department, but efforts to bring about Federal regulation in the area ended when the Supreme Court held that "issuing a policy of insurance is not a transaction of commerce and therefore not subject to the Constitution's interstate commerce clause even when insurance is written across State lines." [3] This effectively prevented any further attempts at Federal regulation for the next 75 years.

However, in 1944, the Supreme Court reversed its decision and held that an insurance transaction crossing State lines is interstate commerce.[4] This decision did not affect the power of the States to regulate insurance, but nullified State laws that were in conflict with Federal laws. To eliminate confusion, however, the McCarran-Ferguson Act [5] was passed in 1945, which generally allowed States to take responsibility for regulating insurance.

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[2] *Ernst & Ernst, GAAP,* 6 (1974).
[3] *Paul* v. *Virginia,* 75 U.S. 168 (1868).
[4] *United States* v. *Southeastern Underwriters,* 322 U.S. 533 (1944).
[5] Public Law 15, Mar. 9, 1945.

The arguments for Federal regulation of the insurance industry are numerous and varied, citing, for example, the lack of uniformity among insurance codes, the additional expense of filing financial reports in different States, the conflict with Federal regulations, and the fact that the national scope of the business would indicate that national uniform laws and reporting requirements are needed.

Conversely, arguments in favor of State rather than Federal regulation include the fact that State regulation can give consideration to local conditions when needed, that Federal regulations would become cumbersome, rigid, arbitrary, and ladened with red tape, and that Federal control would weaken insurance supervision in those States which have a strong code and administration. In the debate over State regulation versus Federal regulation, however, the extraterritorial effect of the New York Insurance Code is often overlooked; as a practical matter it effects some uniform regulation because it requires that any insurer licensed in New York must "substantially comply" with New York law in all States in which it operates.

Scope of State regulatory powers and impact on Federal tax

State insurance codes

Every State has a body of law known as the insurance code which is administered through a Department of Insurance, headed by the Insurance Commissioner. An insurance code regulates the conduct of the insurance industry to ensure that the public's interest is not being compromised, and grants regulatory powers to departments of insurance over the organization and licensing of new insurers, the financial requirements that need to be met by insurers, and the mergers, acquisitions and liquidation of companies.[6] Control of the insurance industry by the States is achieved mainly through their licensing powers. Although license fees may bring in revenues, the number one reason for licensing is control. Commissioners have the power to refuse a license to a new insurer, revoke an existing license, or to deny renewal when a license has expired.

The State regulation of insurers' finances has a substantial impact on the Federal taxation of life insurance companies. The Internal Revenue Code generally requires that computations entering into the determination of the life insurance company taxes be made under an accrual method of accounting, or to the extent permitted under the Treasury regulations, under a combination of an accrual method of accounting with any other recognized method (other than the cash receipts and disbursements method). However, the Internal Revenue Code further provides that, except for this general provision, all such computations shall be made in a manner consistent with the manner required for purposes of the Annual Statement approved by the National Association of Insurance Commissioners (NAIC). This provision of the Code has been interpreted, in some instances, as requiring life insurance compa-

[6] Although mergers and consolidation of companies are controlled by the States, these activities also come under Federal regulation by the Securities and Exchange Commission.

nies to use the same accounting and valuation methods for tax purposes as are used for state regulatory purposes.[7]

Although the Code contains special provisions for computing the taxable income of life insurance companies, these provisions refer to the Annual Statement that is filed with the State insurance departments as the basic underlying financial document for making the tax computations. Although most businesses use their underlying books and records, and the accounting methods used therein, as the basis for computing their tax numbers, life insurance companies use their Annual Statements and the accounting procedures and valuation methods as required under the appropriate State regulations. Often these are not the same figures that are kept on a company's books and records, but are arrived at through adjustments made to conform with the State's regulations. Thus, the State regulations concerning such areas as policy reserves and commission expenses have dictated how much and to what extent income and deductions should be taken into account for Federal income tax purposes.

The influence that State regulation has on the tax treatment of life insurance companies is illustrated by the treatment of reserves for both purposes. The reserves of a life insurance company are estimates of the future liabilities that a company expects to incur with respect to contracts it issues. For example, by issuing contracts and collecting premiums, a company is obligating itself to pay the face amount of the policy to the beneficiary and also to maintain surrender values or guarantees that the insurance will remain in force as long as the insured pays premiums. Although for tax purposes certain liabilities may represent deductible expenses, usually such liabilities are obligations that are definite as to the time and amount of payment (that is, the liability has accrued). However, insurance reserves are a special type of liability. Such reserves are also obligating, but the time and amount of the payment are dependent upon future events. Because reserves increase according to an assumed interest rate, the amount of the future liability is discounted to its present value when deducting it currently.

In the simplest mathematical sense, a reserve is set up for each individual policy.[8] It is assumed that a premium will be paid on a periodic (usually annually) basis which along with an assumed growth (earnings) rate will equal the face amount of the policy at some specified time in the future (maturity of the policy). In reality, companies aggregate policies into blocks of insurance based

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[7] For example, the Supreme Court held that unpaid premiums should be recognized as income, and be reflected in the company's assets and reserves for tax purposes to the extent that the company is required to add them to the State law reserves. This required a hypothetical splitting of the unpaid premium into the "net valuation" portion (the amount State law requires a life insurance company to add to its reserves) and the "loading portion" (the amount to be used to pay salesmen's commissions and other expenses such as State taxes, overhead, and profits). Before, only the "net valuation" portion of the unpaid premium was taxable in the current year, to the extent Treasury Regulations required a different treatment of unpaid premiums, they were held to be invalid as not providing that taxable income be computed in a manner consistent with the accounting requirements approved by the NAIC for use in annual Statements. *Standard Life & Accident Insurance Co.*, 433 U.S. 148 (1977).

[8] During his term as insurance Commissioner of Massachusetts, Elizur Wright created and maintained a registry book listing every policy issued in the State, with yearly calculations showing what the reserve should be at any point. He kept this registry open to all policyholders. (R. Mehr, *Life Insurance: Theory and Practice*, 710 (1977).)

upon the assumptions made for State reserve purposes when issuing the policy.

Interest and mortality assumptions

The growth rate of a reserve is heavily dependent upon two factors. The first factor is the assumed interest rate. The second factor is the assumed mortality factor. A company may use whatever assumptions it deems necessary in pricing a policy, considering economic conditions. The assumptions used in valuing the minimum reserves required for the Annual Statement are mandated in the State regulations. Thus, a company may use one set of assumptions in pricing a policy while it uses a completely different set of assumptions in valuing the reserves for State purposes.

The State's primary concern is that a company remain solvent, that it have enough assets to meet all its obligations to policyholders. In order to help accomplish this goal, States generally have required that life insurance companies use conservative assumptions in estimating the reserve liabilities.[9] Thus, States prescribe the use of certain recognized mortality tables and maximum interest rates. In the past, maximum interest rates have been prescribed by State statutes, but more recently, many States have adopted "dynamic" interest rates. That is, in more than three-fifths of the States, the insurance law provides a formula for calculating maximum interest rates, rather than specifying the rates themselves. The dynamic formula rate is intended to more closely approximate market interest rates and allow for a flexibility when interest rates change with market conditions. It should be noted that the lower assumed interest rates produce reserves that grow more slowly but are larger in size, both initially and throughout the life of the policy. Thus, what is a conservative reserve estimate for solvency purposes may be considered an overstatement of liability for tax purposes.

Reserve methods

In addition to the mortality and interest assumptions, the States also prescribe certain methods of valuation for reserves to ensure that certain minimum reserves are recognized.

As a policyholder ages, the mortality costs increase, and premiums would have to increase correspondingly to cover these increased costs. In order to charge a level premium over the life of the policy, insurers charge premiums that are higher than necessary in the beginning [illegible] that the excess premiums of the early years build up a savings element, which, as it increases, makes the insurance element smaller. That premium (without regard to any loading charges to cover other expenses) which, when accumulated along with the assumed interest and at the assumed mortality rate, will be sufficient to pay the death claim when due, is known as the valuation net premium.

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[9] Use of conservative assumptions provides an interesting result in States that limit the size of the surplus allowed as a percentage of the reserve. Often a company will retain earnings in a contingency or surplus account. As some States limit the amount of surplus as a percentage of reserves, those companies who use more conservative assumptions will have larger reserves and thus a larger allowed surplus. The less conservative company will have smaller reserves and thus a smaller allowed surplus. The result is inconsistent as the more conservative company is less likely to need the surplus for unforeseen contingencies and the less conservative company is more likely to need the surplus.

There are two reserve valuation methods generally permitted by the States, the net level and the preliminary term methods. Under the net level method, the valuation net premium treated as available for the reserve remains constant over the period the premiums are to be paid. As a practical matter, however, first year expenses (e.g., commissions) are high and the loading in the first year gross level premium is unable to cover these costs. Because the net level method assumes that the net premium is available every year for the reserve, a combination of first year expenses and this reserve method can result in a reduction in surplus which could financially impair companies with limited surplus accounts. The preliminary term method includes many variations. Generally, as distinguished from the net level methods, they all provide for the elimination of all or a part of first-year acquisition expenses from the net premium for the first year. This assumes that the entire gross premium, less first-year insurance costs, is available to pay expenses and not needed for the reserve. The reserves are gradually graded up over the premium paying period (or a shorter period) to equal reserves calculated under a net level method.

Generally, net level premium reserves (for an assumed interest and mortality rate) are the highest initially, with the lowest future annual increment of any commonly used method. Because the preliminary term method results in smaller policy reserves in any year, present tax law allows an insurer to revalue its reserves to net level reserves for tax purposes using either an exact method or an approximate method based on a formula. Using the larger net level reserve for tax purposes allows a large exclusion for the policyholders' share of earnings (i.e., the tax-free inside buildup of a policy). Despite the fact that the net level method assumes an amortization of the first-year expenses over the life of the policy, historically, these expenses have been fully deductible in the first year.[10] This revaluation provision is another example of the impact State regulation of insurance has on the Federal taxing provisions.

In summary, the individual States prescribe maximum assumed interest rates, mortality tables, and valuation methods. An insurer must value reserves using assumptions that are within the state's accepted parameters. However, an insurer has a range of flexibility in setting reserves, (e.g., use of net level premium or preliminary term method of valuation or use of any interest rate up to the maximum prescribed), so long as it recognizes reserves at least as large as what would have been calculated using the states parameters.

Cash surrender values

The nonforfeiture value (commonly known as the cash surrender value) in a life insurance policy (or annuity) represents the amount of money due the policyholder upon surrendering his policy. The

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[10] For example, agents' commissions are fully deductible when paid in the first year of a policy, because they are thus stated in the Annual Statement. It is interesting to note, however, that this statement of total commissions was originally required by the Annual Statement as a means of preventing companies from concealing from the public the amount of agents' commissions paid and not necessarily because it was considered a proper reflection of the companies' income. (*Ernst & Ernst GAAP*, 6 (1974).)

public policy underlying nonforfeiture laws recognize that, when a policyholder pays premiums that are calculated under a level premium method, which assumes an overcharge relative to the mortality costs for the early years of a policy, the policyholder is entitled to some form of refund if he surrenders the policy prior to the maturity date. In general, cash surrender values are funded by the premium charge in excess of that necessary to pay for death protection, earnings on that excess premium at a guaranteed rate, and survivorship benefits. The cash surrender value may take several forms. The three most common are a cash payment, reduced paid-up insurance, and extended term insurance.

Prior to the passage of the standard nonforfeiture law in 1948, cash surrender values were computed generally as the reserve of a policy less a charge to recoup some of the high first-year expenses. Under the Standard Nonforfeiture Law, a minimum cash value is prescribed and computed (similar to a reserve) using certain actuarial assumptions, specifically, the present value of the insurer's future policy obligations less the present value of the adjusted premiums. The adjusted premium is the net level premium plus a certain defined first-year expense allowance. Although cash surrender values may exceed the minimum (but not the policy reserve), the objective of a minimum cash value is to ensure that each policyholder receives an equitable share in the insurers' assets upon surrender of his policy without jeopardizing the position of the continuing policyholders. Thus, today there is generally no relationship between the cash surrender value and the reserve, and no surrender charge is imposed.

B. Accounting Practices

The accounting methods used by life insurance companies in preparing their numerous statements depend upon what document is being prepared and for whom it is being prepared. As a result, different documents will contain similar accounts but the amounts shown in these accounts will not be comparable because of the different accounting methods used.

Generally speaking, a life insurance company keeps its ledgers on a cash basis. The preparation of the annual statement requires the use of statutory accounting practices (SAP). Statutory accounting practices are those methods which follow State regulations. The Annual Statement, therefore, is prepared on an accrual basis, rather than on the cash basis, to reflect more accurately the company's financial position on the statement date. Life insurance companies which must make an Annual Report to stockholders generally must have that report prepared using Generally Accepted Accounting Principles (GAAP) as promulgated by committees appointed by the American Institute of Certified Public Accountants (AICPA). Since mutual companies do not have shareholders, there is no securities' reason to have their accounts examined in accordance with GAAP. Thus, statements prepared using GAAP are usually available only for the stock life insurance companies.

Generally, for tax purposes, an accrual accounting method must be used and computations must be made in a manner consistent with the manner required for purposes of the Annual Statement approved by the National Association of Insurance Commissioners.[11]

1. Differences in generally accepted accounting practices and statutory accounting practices

The purpose of the Annual Statement is to indicate the solvency of the insurer. Therefore, statutory accounting is oriented towards valuation with emphasis on the balance sheet rather than the income statement. This is evident from examining the accounting procedures for valuation of assets (stocks, bonds, etc.) and liabilities (policy reserves). In contrast, generally accepted accounting principles address themselves primarily to the allocation of revenues, costs, and expenses (i.e., the emphasis is on the income statement rather than the balance sheet). "The complications of these conflicting orientations are profound. In one case, the income statement (or the income and surplus statement combined) is a repository for adjustments arising in the balance sheet valuation process. In the other case, the balance sheet is a repository for adjustments

[11] Code sec. 818(a).

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arising in the process of allocating revenues, costs, and expenses to accounting periods." [12]

Inherent uncertainty in, and use of actuarial assumptions to determine, the liabilities for contracts that guarantee performance over long periods of time result in the adoption of conservative assumptions as a fundamental concept underlying statutory accounting procedures. However, generally accepted accounting principles, require that such conservatism must be reasonable and realistic.[13] The object of statements prepared in conformity with generally accepted accounting principles is to provide reliable financial information about a business' economic resources and obligations measured as a going concern. As a general rule, therefore, GAAP accounting is more concerned with presenting the true economic picture of a company and the matching of current income to current expenses as opposed to SAP accounting which is more concerned with a company's solvency. The major areas of difference between GAAP accounting and SAP accounting which their differing goals create are in the valuation of reserves and the recognition of large first-year expenses.

a. Reserves

The concept behind statutory reserves is to guarantee that reserves are adequate and in accordance with statutory requirements. To meet this objective, State laws regulate the methods of valuation, the selection of mortality tables, and the maximum interest rates assumed. More often than not, an insurer will use one set of assumptions when pricing a policy and another for State valuation purposes. For example, an insurer may use a currently projected long-term interest rate and a mortality table based upon actual experience in the pricing of a policy. However, for State valuation purposes, it may have to use a recognized mortality table which has been loaded to predict more deaths at younger ages and a lower assumed interest rate which implies the need for greater initial reserves. The amount of reserve needed to fund the policy will vary according to the assumptions used.

GAAP accounting recognizes that these differences exist and attempts to value a reserve on a basis that more closely approximates the true economic picture. To accomplish this goal, reserves are revalued using assumptions that more closely approximate market conditions (i.e., assumptions much closer to those used in pricing).

b. First-year expenses

Another major difference between SAP accounting methods and GAAP accounting methods is in the treatment of the high first year policy acquisition expenses. Commission charges are shown as an expense on the Summary of Operations page in the Annual Statement. Generally, taxpayers claim a full deduction for commission expenses for State regulatory and tax purposes [14] in the acqui-

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[12] *Ernst & Ernst, GAAP* 6 (1974).

[13] American Institute of Certified Public Accountants, *Audits of Stock Life Insurance Companies*, 64 (1979)

[14] This current deduction treatment apparently arose from a desire to force disclosure of the full magnitude of commissions.

sition year regardless of the valuation method chosen by the insurer. Under GAAP accounting, the first year acquisition expenses are deferred and amortized thus more clearly matching expenses to the revenues they create.

2. Differences in tax and statutory accounting

The Code generally requires that all computations entering into the determination of the life insurance company taxes be made under an accrual method of accounting, or to the extent permitted under Treasury regulations, under a combination of an accural method of accounting with any other recognized method (other than the cash receipts and disbursements method). However, the Code further provides that, except for this general provision, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners (NAIC).

Despite its reliance on SAP accounting policies, tax accounting provisions still require for tax purposes that a number of items either need be added to or subtracted from the accounting shown on the Annual Statement. Generally, these adjustments relate to asset carrying values and the recognition of income and expenses. The most important of these differences relates to the revaluation of preliminary term reserves to net level reserves for tax purposes. The other differences are described below.

Current earnings rate

The current earnings rate is the investment yield divided by the mean of the assets. Under Federal tax law, the current earnings rate is needed to calculate the policyholder's share of a life insurance company's investment income. In computing this rate, nonadmitted assets [15] that may not be shown in the Annual Statement's Balance Sheet must be taken into account (other than real and personal property used by it in carrying on an insurance trade or business.)

Interest income

The Annual Statement includes adjustments to interest income to reflect discount accrual and premium amortization for both taxable and tax-exempt bonds. Unlike other corporations, current law provides that in the case of insurance companies, market discount is excluded from interest income. Market discount is realized on a disposition of a bond and receives capital gain treatment.

Advanced interest on policy loans

When policyholders borrow money against their life insurance, the company generally requires the first interest payment in advnace, then annually on the policy anniversary date. Generally, policyholders do not pay the interest, but have it added to the loan balance. The Revenue Service, four circuit courts, and the Court of Claims, treat the advance interest on policy loans, whether collect-

[15] Generally, a nonadmitted asset is an item such as furnishings, a past due receivable, or a second mortgage that may not be considered in determining whether assets equal or exceed obligations to policyholders.

ed or added to principal, as includible in income in the year received. The Tax Court has held to the contrary.

Dividend income

The Annual Statement includes intercorporate dividends that have been accrued but not received as income. For tax purposes the dividends must be received or otherwise made unqualifiedly available to the distributee.

Capital gains

Net realized and unrealized capital gains and losses appear in the Annual Statement as an adjustment of surplus but not in the Summary of Operations. For tax purposes, only realized capital gains or losses are considered.

Expenses

The Annual Statement treats furniture and equipment as nonadmitted assets and deducts them in full in the Summary of Operations. In computing the tax expense, these items must be capitalized and depreciated. Real estate expenses and taxes attributable to company occupied premises are generally charged against investment income in the Annual Statement. Under the tax rules, these expenses must be allocated between investment expenses and general insurance or underwriting expenses.

Bad debts

A life insurance company may establish a reserve for bad debts in the Annual Statement. The Federal tax law prohibits the use of the reserve method for life insurance companies. For tax purposes, the specific charge off method must be used.

IV. TAXATION OF LIFE INSURANCE COMPANIES

A. Overview

1. Pre-1959 taxation

Aside from the special taxing provisions for insurance companies (subchapter L of the Code), regulation of the insurance industry is left to the States under the McCarran-Ferguson Act.[1] Before 1921, insurance companies were taxed in substantially the same manner as ordinary corporate entities. Since 1921, insurance companies have been subject to special tax provisions. For tax purposes, insurers have been classified into three groups: life, mutual other than life, and other stock companies.[2] Under the Revenue Act of 1921 and subsequent legislation, life insurance companies were accorded a special tax treatment, presumably stemming from the difficulty of determining in any one year the income derived from the long-term insurance contracts.

From 1921 through 1957, a life insurance company's gross taxable income included only investment income. Premiums were excluded from the income computation, as were losses and expenses incurred in underwriting operations, and gains and losses from the sale of investment assets. Various formulas were established to exclude from taxation the portion of investment income necessary to satisfy the company's obligations to policyholders under its insurance contracts and, though the formulas varied from time to time, their purpose was always to compute that portion of investment income allocable to policyholders. This approach of taxing income only to the extent not needed to fund current and projected liabilities to policyholders as determined under State law has been referred to as taxing a company on its free investment income.

2. The 1959 Act

The general framework under which life insurance companies are taxed presently was adopted in the Life Insurance Company Income Tax Act of 1959 (secs. 801–820 of the Code).[3] The 1959 Act significantly changed the manner in which life insurers were taxed by adopting a total income concept as the general approach for taxing life insurance companies; that is, both investment earnings and gains (or losses) from underwriting operations were included in taxable income. However, since mutual insurance companies would be permitted to deduct policyholder dividends, there was concern

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[1] Public Law 15, March 9, 1945.

[2] A fourth classification, insurance companies that are exempt from tax under sec. 501(c)(8), (9), (12) and (15) is composed of fraternal beneficiary societies, voluntary employees; beneficiary associations, local benevolent life and mutual associations, and certain mutual insurance companies other than life or marine.

[3] Public Law 86-69, June 25, 1959. The Act was generally effective for taxable years beginning after December 31, 1957.

that they could reduce their Federal tax burden below the level of prior law.[4]

As a result, limitations were imposed on the deduction of policyholder dividends that generally preserved as a minimum tax base, the free investment income of life insurance companies. Also, to lessen the impact of including underwriting income in the tax base for the first time and because it might be difficult to accurately determine underwriting income on an annual basis, tax on one-half of the underwriting income was allowed to be deferred. Unlike the formulas used previously, the 1959 Act determined the reserve and other contract liability requirements on a company-by-company basis rather than on the basis of a uniform percentage of investment income applied to the entire industry. The required investment income deduction took into account the earnings rate of individual companies as well as the interest assumed in computing reserves under State law. Thus, although life insurance companies are taxed at the corporate rate, their taxable income is computed differently from other taxpayers.

In determining its taxable income under the 1959 Act, a life insurance company must make two income computations—its gain (or loss) from operations and its taxable investment income. The computation of gain from operations begins with the company's total income including the company's share of investment yield,[5] net capital gain, premiums and other considerations, decreases in insurance reserves, and all other amounts. From this total, a life insurance company is allowed deductions. These generally include the usual deductions available to taxpayers for business or investment, an operations loss deduction, and certain deductions unique to the insurance business such as for payments of claims and death benefits, for increases in reserves (to the extent not funded out of the policyholder's share of investment income), and for payments under assumption reinsurance. In addition, a deduction is allowed for the company's allocable share of tax-exempt income and the dividends received deduction. The initial inclusion of tax-exempt income followed by the later deduction of the company's share has the effect of allocating a portion of tax-exempt income to the policyholder's share which is not includible in the company's taxable income in any event. Thus, tax-exempt income is not as attractive to life insurance companies as to other corporations as a means of reducing taxable income. All companies are also permitted to claim a small business deduction. Finally, there are three special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts, which are subject to limitations. Unlike the deduction for policyholder dividends, the other two special deductions do not reflect actual cash expendi-

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[4] Generally, the ownership of life insurance companies is either mutual or stock in nature. Mutual companies are owned by the policyholders and premiums are often reduced by distribution of policyholder dividends. Policies in which premiums are reduced in the form of policyholder dividends are known as participating policies. Stock companies are owned by stockholders who receive the profits of the company through regular corporate dividends. Like any other corporation, such dividends are not deductible by the corporation.

[5] The computation actually begins with gross investment income, less investment expenses, from which the interest contractually required to be set aside for policyholders (the policyholders' share of investment yield) is excluded.

tures by the company or even the commitment of funds to a reserve required under State law.

To compute taxable investment income, a company may deduct all applicable investment expenses from its gross investment income. Also the company is allowed to exclude that amount which, together with premiums, is required to fund the benefits of the policies (the policyholders' share of investment yield).[6] The company may deduct its share of tax-exempt investment income and the dividends received deduction from its share of investment yield.

Under the 1959 Act and present law, the computation of a life insurance company's taxable investment income is important for two purposes. First, it defines a limitation on the aggregate amount allowed for the special deductions under the gain from operations computation. Provisions of the 1959 Act, stipulate that the amount of deductions allowed for policyholder dividends, for nonparticipating contracts, and for accident and health and group life insurance contracts is limited to the amount by which gain from operations (before those deductions) exceeds taxable investment income, plus $250,000.[7] This limitation was designed to ensure that most large companies were subject to tax at least on their free investment income (reduced by no more than $250,000).

Second, the taxable investment income computation determines the taxable income base of the company and whether any part of the company's income can enjoy tax deferral. If the gain from operations is less than or equal to taxable investment income, the company is taxed on its gain from operations. If the gain from operations exceeds taxable income, the company is taxed on taxable investment income plus one half of the excess of gain from operations over taxable investment income. The tax with respect to the other half of the excess of gain from operations over taxable investment income is deferred. That half (along with amounts deducted for nonparticipating contracts, and for accident and health and group life insurance contracts) is added to a policyholders' surplus account and, subject to certain limitations, is taxed only when distributed to shareholders of a stock company or upon corporate dissolution.

The provisions described above for computing a life insurance company's taxable income require a comparison of its taxable investment income and its gain from operations. Depending on whether income is characterized as investment income or underwriting income, a company can have a different tax liability. The result is that most life insurance companies can be classified as being in one of three tax phases.

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[6] Under the taxable investment income computation, the policyholders' share of investment yield is determined in part by use of the "Menge formula," which arithmetically adjusts State required life insurance reserves to allow the crediting of earnings at an adjusted rate that takes into account the actual earnings at an adjusted rate of the individual companies. In general, the effect of these computations is to allocate to the policyholder an amount at least equal to the reserves required under State law except, under the permanent provisions, if the current earnings of the company exceed 10 percent. The 1959 Act does not establish a Federal standard for computation of reserves or require that they be based on a company's actual experience.

[7] This limitation was changed under TEFRA, making the statutory dollar amount $1 million and phasing that amount down to zero for larger life insurance companies.

Phase I company

Under 1959 Act, a Phase I company has a gain from operations that is less than its taxable investment income by exactly $250,000 because it has reached the limit for deduction of policyholder dividends and certain other amounts. A life insurance company that would typically be in this phase is an established mutual company (owned by its policyholders), which might have substantial gains from its insurance business (i.e., underwriting gains) before any policyholder dividend distributions. This company could use the deduction for policyholder dividends to reduce gain from operations, but not below an amount equal to taxable investment income, less $250,000.

Phase II (Positive) company

A Phase II (Positive) company has a gain from operations in excess of its taxable investment income. A typical life insurance company taxed under this phase would be an established stock company (owned by shareholders), which has no State law requirement to share favorable investment and underwriting experience with its policyholders through policyholder dividends. A stock company can distribute excess funds to shareholders. A Phase II (Positive) company's taxable income is generally the sum of its taxable investment income and one-half of the excess of its gain from operations over taxable investment income. Because a company's gain from operations is roughly the sum of its taxable investment income and its underwriting gain, a Phase II (Positive) company is taxed currently on one-half of its underwriting gain while the other half becomes part of the deferred tax account (policyholders' surplus account).

Phase II (Negative) company

A Phase II (Negative) company has a gain from operations that is less than its taxable investment income by more than $250,000 (under the 1959 Act) because of underwriting losses. Typically, a Phase II (Negative) company is a new or growing stock life insurance company that has underwriting losses from its insurance business because start-up costs associated with new insurance business are high in proportion to its total insurance business. In such a case, taxable investment income is reduced by the expenses of operating the company because the underwriting income alone is not sufficient to cover the costs of the insurance business. A Phase II (Negative) company's taxable income is its entire gain from operations.[8]

Because of the three-part or multiphase approach to life insurance company taxable income under the 1959 Act, the same financial course of action taken by two life insurance companies, each in a different phase of taxation, will have different tax consequences. Each company must, therefore, not only determine its present tax

[8] In addition to the three tax phases discussed above, there is also a "Phase I Corridor" company, which is taxed on its entire gain from operations that is less than taxable investment income by an amount less than $250,000 (under the 1959 Act), and a "Phase III" company, which has taxable income that includes shareholder distributions of previously tax-deferred amounts from the policyholders' surplus account.

position, but also estimate its future position in order to evaluate the results a contemplated transaction will have on its tax liability.

3. TEFRA changes

With inflation, the rise in interest rates, and the rapid evolution of new insurance products, the provisions of the 1959 Act allowed the computation of life insurance company taxable income to become distorted. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress took steps to eliminate certain tax avoidance techniques. TEFRA contained some permanent tax provisions to correct certain identified inadequacies of the 1959 Act, as well as some temporary provisions (effective, generally, for 1982 and 1983) to allow a more thorough Congressional review of the tax law applicable to life insurance companies and their products.

Modco and reinsurance

The special provisions governing modified coinsurance transactions were permanently repealed. Likewise, conforming provisions were adopted to prevent similar abuses through dividend reimbursement agreements between insurance companies engaged in reinsurance transactions, to deny deductions for interest paid on indebtedness used in reinsurance transactions, and to grant the Treasury special income allocation and recharacterization authority with respect to reinsurance transactions between related parties.

Special deductions

TEFRA adopted a temporary change in the limitation on the special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts. This provision generally raised the statutory dollar amount (from $250,000 to $1 million), but targeted it to small life insurance companies under the 1959 Act. The provision also offered an alternative limitation on the special deductions equal to 100 percent of policyholder dividends on pension contracts, $1 million, and a fixed percentage (85 percent for stock companies and 77½ percent for mutual companies) of the tentative deduction for other than pension plan related policyholder dividends and nonparticipating contracts. For most companies, this alternative is substantially more generous than the limitation provided under the 1959 Act.

Computation of reserves

TEFRA contained a number of temporary provisions involving computation of insurance reserves. First, interest guaranteed in excess of the assumed rate cannot be taken into account in computing the life insurance reserves to the extent such excess interest is guaranteed beyond the taxable year. Second, in determining the contract liabilities for group pension funds, the exclusion allowed a life insurance company is limited to the amount actually credited to such contracts. Both of these provisions have the practical effect of reducing the exclusion for the policyholders' share of investment yield. Third, the status of a life insurance company cannot be changed because of its reserve treatment of group pension funds. This prevents reclassification of life insurance companies as casualty insurance companies (for tax purposes)—which would be adverse

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to certain stock companies and favorable for certain mutual companies—because they have removed life contingencies from the pension contracts. Fourth, an arithmetic adjustment to reserves contained in the 1959 Act (the Menge formula) was changed to a geometric adjustment, allowing a slightly more generous policyholders' share of investment yield. In addition to these temporary changes, there was a permanent reduction in the amount allowed a life insurance company under the approximate formula for revaluing preliminary term reserves: Reserves are increased by $19 per $1,000 insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 insurance in force and reduced by 2.1 percent under prior law).

Consolidated returns

There is a temporary provision which allows related life insurance companies to compute their respective taxable incomes before consolidation for filing tax returns (a bottom-line method). This method is allowed instead of requiring consolidation of income items before computing a consolidated taxable income.

Annuities

TEFRA also contained permanent changes for the tax treatment of annuity contracts with respect to both companies and policyholders. In general, companies are allowed the full deduction for amounts credited for annuity contracts. For a policyholder, cash distributions from an annuity contract before the annuity starting date are taxable to the policyholder to the extent there is income in the contract. Also, if a portion of such an income distribution is attributed to an investment in the contract that was made within 10 years of the distribution, there is a 5-percent penalty tax on such portion. Together with certain other exceptions, no penalty tax applies to income distributions on or after the policyholder reaches age 59½.

Flexible premium life insurance

Finally, TEFRA adopted temporary guidelines with respect to flexible premium life insurance contracts (i.e., universal life and adjustable life), which must be met in order for the death proceeds from such contracts to be considered life insurance for tax purposes.

B. Details of Present Law and Related Issues

This section describes the provisions of the 1959 Act and TEFRA changes in greater detail, and identifies some of the issues that are raised or addressed by those provisions.

1. Qualification as a life insurance company (sec. 801)

Under present law, a company is taxed as a life insurance company if it satisfies two requirements. First, the company must be an insurance company [9] which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance. Second, the company's life insurance reserves, plus unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, health, or accident policies not included in life insurance reserves, must comprise more than 50 percent of its total reserves.

Life insurance reserves are amounts (1) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) which are set aside to mature or liquidate future unaccured claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts involving, at the time when respect to which the reserve is computed, life, health, or accident contingencies. Generally, life insurance reserves must be required by State law. The term total reserves means (1) life insurance reserves, (2) unearned premiums and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law.

Deficiency reserves

The definition of a life insurance company and life insurance reserves under the 1959 Act was, in general, the same as that contained in the then existing law. However, the 1959 Act added an additional provision which excluded from the term "life insurance reserves" any deficiency reserves (sec. 801(b)(4)). A deficiency reserve is defined as that portion of the reserve for a contract equal to the excess (if any) of the present value of future net premiums over the present value of future actual premiums and considerations charged for such contract.

As a practical matter, a deficiency reserve arises and is required under State law when a company charges a premium which is less than that which would be necessary to fund the reserve given the

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[9] The Treasury regulations define the term "insurance company" as meaning a company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The term insurance company is not defined anywhere in the Code.

assumptions adopted by the insurer for purposes of computing its reserves under State law. Given the particular language of the Code, which defines deficiency reserves in terms of future net premiums and future actual premiums, the issue arises whether an insurance company can have a deficiency reserve with respect to a single premium contract since there will be no future premiums. Although this issue arises under present Code language, it is interesting to note that in the House version of the provision under the 1959 Act (which was not adopted), a deficiency reserve was defined in terms of the difference between (1) the net premiums for certain life insurance and annuity contracts deemed under State law to be necessary, and (2) the actual premiums and consideration charged for such contracts. Under such a definition, a deficiency reserve could exist with respect to single premium contracts.

Total reserves

Although the Code defines life insurance reserves, it does not define insurance reserves. Rather, the definition of insurance reserves must be discerned from case law and can require consideration of the fundamental question: What is insurance? Although this question has been considered by several courts (including the Supreme Court), there is still no "definitive" definition. Compare *Helvering* v. *LeGierse,* 312 U.S. 531 (1941) and *Consumer Life Insurance Co.* v. *United States,* 430 U.S. 725 (1975).

The definitional problem of what is insurance and what is an insurance reserve is aptly illustrated in life insurance tax law by the controversy over the treatment of certain pension funds. Under current law, a life insurance company may assume for tax purposes that income is credited to pension plan reserves (life insurance reserves that are held for the benefit of certain pension contracts) at the current earnings rate. In recent years, companies have wanted to credit earnings to pension funds at "new money" rates that were higher than the current earnings rate on all assets. Companies have avoided the current earnings rate assumption required by the Code for pension plan contracts by deleting life contingencies from the contracts and guaranteeing new money interest rates on pension plan funds (sec. 810(b)(3)(C)). Without such life contingencies (which means that the company holds the funds without guaranteeing any annuity purchase rates upon retirement), the pension plan funds do not meet the definition of life insurance reserves and, accordingly, are not pension plan reserves.[10] However, the question remains whether the removal of these contingencies causes these funds to be mere deposits with the companies and not insurance reserves at all.

When a company assumes only the risk of paying a guaranteed amount, that is, it assumes only an investment risk, does the contract involve insurance which would cause such funds to be set aside in an "insurance reserve"? Certain court cases have held that the assumption of a mere investment risk does not constitute insurance, because an investment risk is not an insurance risk. Although the assumption of such an investment risk is akin to the

[10] The term "pension plan reserves" means that portion of the *life insurance reserves* which is allocable to pension plan contracts.

type of risk assumed by many banks, the court cases are far from definitive.[11] From a life insurance company tax viewpoint, the answer to this question can have tremendous practical significance (either a reduction in taxes paid or recognition of tax-deferred income), if the tax treatment of such pension funds causes the company to be classified as an insurance company other than life. For example, a mutual company that fails to qualify as a life insurance company because of the treatment of pension plan contracts that do not involve life contingencies will find itself with a tax advantage because it will be taxed as a nonlife mutual insurance company, which is allowed 100 percent deduction of its policyholder dividends, instead of as a life insurance company, which is allowed currently a 77-½ percent deduction of such distributions. On the other hand (sec. 832(c)(11)), a stock company that fails to qualify as a life insurance company (for any two successive years) may be required to recognize, in the last taxable year for which it was a life insurance company, all the income that was tax-deferred by operation of the policyholders' surplus account (sec. 815(d)(2)).

Contracts with reserves based on segregated asset accounts

The 1959 Act also contained special provisions for variable annuity contracts, that is, for contracts that provided for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract (sec. 801(g)). These special provisions were expanded in 1962 to include contracts with reserves based on a segregated asset account. This change recognized the fact that variable annuity contracts were also sold by companies that did not specialize in such contracts but offered them as an alternative to traditional insurance contracts.

A "contract with reserves based on a segregated asset account" is a contract that (1) provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law and regulation, is segregated from the general assets of the company, (2) that is a contract under a pension plan or that provides for the payment of annuities, and (3) under which the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account. If a contract ceases to reflect current investment return and cur-

[11] The question of what constitutes insurance may have a broad practical significance in areas other than life insurance. For example, this question is central in the fact situation of retroactive insurance under which a policyholder obtains insurance against a particular risk after the event of the risk has occurred. If it is insurance, the tax accounting for such a transaction may make the contract profitable: the policyholder may be entitled to an immediate deduction for a premium, which has been discounted at interest, taking into the consideration the fact that the actual claims will be paid over a long period of time; at the same time, the insurance company selling the contract recognizes the liability for the accrued claims on an undiscounted basis. Thus, the transaction apparently takes advantage of what might be viewed as a mismatching of income and deductions, as between two unrelated taxpayers.

The question of what is insurance, also, is pertinent in certain areas which are outside the traditional commercial insurance business. For example, in the area of sureties and warranties, there is an argument that such contracts constitute insurance and companies issuing such contracts should be taxed as insurance companies, able to avail themselves of certain special and advantageous accounting provisions available only to insurance companies.

Finally, the question is central for any analysis of self-insurance plans and consideration of whether there can be valid insurance transactions between economically related parties, specifically, the captive insurance area.

rent market value, it is no longer a contract with reserves based on a segregated asset account.

Special Code provisions recognize variable contracts for pension plans or annuities as insurance products, although, arguably, they are primarily investment contracts because the investment risk is borne by the policyholder rather than the life insurance company. The bearing of the investment risk by the policyholder was the factor that the Surpeme Court identified in concluding that such contracts, for securities purposes, are securities and not insurance contracts (*SEC* v. *Variable Life Insurance Company of America,* U.S. (359 U.S. 65 (1959)).

The provisions which were originally tailored for variable annuity contracts and later expanded to cover contracts based on segregated asset accounts do not cover the newer variable life insurance contracts. Under a variable life insurance contract, the policyholder does not bear the entire investment risk, because a minimum amount of life insurance protection is guaranteed in the contract. However, the face amount of the coverage will increase and decrease above this minimum to reflect the value of assets in the underlying account (and cash value of the contract). Without special provisions like those for contracts with reserves based on segregated asset accounts, the variable character of this life insurance raises difficult questions concerning its tax treatment under the general taxing provisions for traditional life insurance products. (For example, are increases in life insurance protection policyholder dividends subject to the special limitation?

Tax imposed (sec. 802)

Under present law, every life insurance company is taxed on its life insurance company taxable income for the taxable year. That tax is computed by applying the general corporate tax rates. Life insurance company taxable income is specifically defined as the sum of (1) the taxable investment income or, if smaller, the gain from operations, (2) if the gain from operations exceeds the taxable investment income, an amount equal to fifty percent of such excess, plus (3) the amount subtracted from the policyholders' surplus account for the taxable year. Thus, although life insurance companies are taxed at the normal corporate rate, the 1959 Act provides special accounting rules for computing their taxable income. As with other corporate taxpayers, however, the net capital gain which is taxable to the company may be subject to an alternative tax.

The specific imposition of the corporate tax on the taxable income of a life insurance company is similar to the provisions imposing tax on nonlife mutual insurance companies as well as all other nonlife insurance companies. The use of these special provisions to impose the corporate tax raise the question of what is an insurance company.

An insurance company is not defined in the Code; however, there is a definition in the regulations under the life insurance provisions. Under the regulations, the term insurance company means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The

regulations state that although its name, charter, powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, the character of the business actually done in the taxable year will determine whether a company is taxable as an insurance company.

This definition of an insurance company is peculiar in that it focuses on the character of the business activity carried on by the taxpayer rather than on the form of organization adopted by the taxpayer. The fact that the special tax imposition provisions exist may lead one to conclude that, but for such provisions, the taxable income of an insurance company would not necessarily be subject to the corporate tax. Arguably, one might conclude that whatever the form of the taxpayer insurance company, its taxable income will be subject to the corporate tax rate. The conclusion that insurance companies must be specifically included in order for general corporate provisions to apply to all of them may be supported further by the definition of "corporation" in the Code. The term corporation is defined to include associations, joint stock companies, and insurance companies.

With the establishment of insurance exchanges in recent years, the question of whether only incorporated entities may be insurance companies for tax purposes or whether all insurance organizations are treated as corporations for tax purposes has become significant. Specifically, if a limited partnership operating as an insurer on an insurance exchange has as its predominant business activity the issuing of insurance contracts or the reinsuring of risks underwritten by insurance companies, should it be taxed as a corporation or as a partnership? This question is more troubling when an individual acts as an insurer on an insurance exchange.

2. Computation of life insurance company taxable income

Although taxed at the corporate rate, the taxable income of a life insurance company is computed differently from other taxpayers. As indicated earlier, the 1959 Act provided a tax base for life insurance companies that consists potentially of three parts: (1) taxable, or "free," investment income; (2) one-half of any underwriting gain (or, more accurately, one-half of any excess of gain from operations over taxable investment income); and (3) to the extent distributed to shareholders, the remaining gain from underwriting. This latter part, the deferred tax on income when distributed, applies only if more than the amounts already subject to tax under the other parts is distributed to shareholders.

a. Taxable investment income (sec. 804)

The first part of the life insurance company tax base is taxable investment income, which is defined as an amount (not less than zero) equal to the net capital gain plus the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest and dividends received), reduced by the sum of (1) the life insurance company's share of tax-exempt interest and dividends received deduction, and (2) a small business deduction.

Thus, computation of taxable investment income requires a determination of the amount of net investment income that is "free"

or not required for life insurance reserves and other contract liabilities, and therefore is subject to tax. In making this determination, step 1 is to determine gross investment income. Gross investment income includes interest, dividends, rents, royalties, net short-term capital gains, and income from the operation of a trade or business (other than the insurance business). Such gross investment income also includes any tax-exempt interest or dividends received. Deductions are allowed (step 2) for investment expenses, real estate expenses, depreciation, depletion, and other trade or business deductions attributable to any business (other than the insurance business) carried on by the life insurance company.[12]

After obtaining net investment income, or investment yield, step 3 is to determine the company's share of this income. The company is taxable on that portion of investment yield not set aside to meet policy and other contract liability requirements such as life insurance reserves, pension plan reserves, or "interest paid" on supplementary contracts, dividend accumulations, prepaid premiums, indebtedness, and special contingency reserves. Finally, step 4 in arriving at the company's taxable investment income requires that net capital gain (if any) be added to the company's share of the investment yield, the sum of which is reduced by the company's allocable portion of tax-exempt interest and intercorporate dividends received (both of which were included in gross investment income), and by a small business deduction equal to 10 percent of the investment yield for the taxable year (not to exceed $25,000).

(1) Investment yield

The Federal tax laws have segregated investment income from underwriting income since 1921; however, the methods to be used in allocating costs between these two categories of income are still uncertain. For example, although the salaries of employees who work only in the investment department are clearly investment expenses, it is unclear whether or how the salaries of employees who contribute to both the investment function and the underwriting function of the company should be allocated.

In addition, there are some expenses for which the proper rationale for any allocation may be difficult to determine. For example, the commissions paid to the agents and premium taxes are large expenses incurred by all life insurance companies. The commissions often can equal the gross premiums paid for the policy in the first year or two, and may be paid to the agents all in the first year. The commissions are paid to agents for the sale of insurance contracts, and premium taxes are levied on receipts arising from such sales. From this perspective, both types of expenses constitute underwriting expenses. However, if one views a life insurance contract as involving both the sale of insurance protection and the sale of an investment, then some portion of the agent's commissions and premium arguably could be treated as an expense of acquiring capital for the investment portion of the contract. Under such a characterization, some portion of both expenses might appropriately be deductible as investment expenses by the company.

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[12] If any general expenses of the insurance company are in part assigned to or included in the investment expenses, the total deduction of investment expenses is subject to a limitation.

(2) Policy and other contract liability requirements (Sec. 805)

After a life insurance company determines its investment yield, each item of such yield is allocated between the policyholders and the company in the same proportion that the company's policy and other contract liability requirements bears to its total investment yield. These policy and other contract liability requirements are, for any taxable year, (1) the adjusted life insurance reserves, multiplied by the adjusted reserved rate, (2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and (3) interest paid.

The first item (the adjusted life insurance reserves, multiplied by the adjusted reserves rate) measures that amount of investment income that, for tax purposes, is deemed necessary to be set aside for the policyholders in order to meet the liabilities under contracts that involve life contingencies (other than pension plan contracts) under the operation of what is commonly referred to as the "Menge" formula.[13]

Under the 1959 Act, the Menge formula requires a mechanical, arithmetic adjustment to life insurance reserves. The practical effect of the application of this formula was to allow life insurance companies an excludable policyholders' share of investment yield that was larger than the share would have been if it had been computed on the basis of the contractually assumed interest rate. As adjusted earnings rates rise, the excludable policyholders' share (determined under the Menge formula) reaches a maximum, and then begins to decline even as the earnings rate continues to rise. This reversal in the size of the policyholders' share of investment yield can theoretically continue until the share is smaller than that which is contractually required (even to zero). However, in no event does this extreme hardship occur until the adjusted reserves rate exceeds 10 percent. To forestall this reversal below the maximum amount possible under the arithmetic formula, TEFRA temporarily substituted a geometric Menge formula, which allows a larger policyholder share of investment yield and delays even further any reversal effect as earnings rates climb. In general, the Menge formula was adopted under the 1959 Act to allow insurance companies to reflect their current earnings rate in determining their policyholder share and to preclude companies from taking advantage of conservative assumptions in computing reserves to maximize their exclusion from taxable investment income.

With respect to pension plan reserves (the second item), life insurance companies are allowed to credit earnings at the current earnings rate. This was intended to give companies the full benefit for earnings credited and to allow them to compete with otherwise tax-exempt pension trusts. The general policy of allowing life insurance company pension funds tax treatment equivalent to that of tax-exempt pension trusts was renewed under TEFRA, which

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[13] That is, life insurance reserves are reduced by 10 percent for every percentage point difference between the average assumed rate of interest for the contracts and the adjusted reserves rate (which is the lower of the average earnings rate over the last five years, or the current earnings rate) so that life insurance reserves can be credited with an adjusted reserves rate which reflects the current earnings rate of the individual companies.

allows temporarily a full deduction for any policyholder dividends paid on pension funds.

In addition, TEFRA temporarily resolved a technical tax loophole in the pension funds area. Under the 1959 Act, life insurance companies were allowed, for tax purposes, to allocate investment yield to pension plan reserves on the basis of the current earnings rate even if that rate exceeded the rate guaranteed under the contract. However, if the guaranteed rate of interest exceeded the current earnings rate, a company could allocate investment yield at the guaranteed rate rather than the current earnings rate by removing life contingencies from the contracts. For taxable year 1983 only, the potential double exclusion [14] for certain pension plan earnings is prevented because the policy or other contract liability requirements for group pension contracts (for purposes of determining the excludable policyholders' share of investment yield) is limited to the amount actually credited to the contracts (in whatever form).

The third item, interest paid, is defined under present law to be the sum of (1) interest paid on indebtedness (except on indebtedness incurred to purchase or carry tax-exempt obligations), (2) amounts in the nature of interest (whether or not guaranteed), for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health or accident contingencies, (3) discount on prepaid premiums, (4) interest on certain special contingency reserves, and (5) certain qualified interest with respect to annuity contracts.[15]

This provision of present law combines interest paid on indebtedness (whether paid to a policyholder or otherwise) with "interest" or earnings credited under contracts with policyholders. This treatment might be questioned, given that interest on indebtedness might be characterized more properly as an investment expense in certain situations. For example, interest could be an expense arising from a trade or business (other than insurance business) carried on by a life insurance company or by a partnership of which the life insurance company is a partner. Assume a life insurance company loans money for a joint real estate venture in which it is also a partmer. As the lender, the life insurance company will receive interest income which is included in its gross investment income; as a partner in the venture, the insurance company will be considered to pay its proportionate share of the interest on the loan made to the partnership. If the interest paid were an investment expense, there would be a dollar-for-dollar offset of interest income included in gross investment income and interest expense. However, under the special provisions for computing investment yield and the company's share thereof, interest paid on indebtedness is treated as a policy or other contract liability which is taken

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[14] This can occur because a company can get a full deduction for "new money" rates guaranteed on new pension funds while at the same time the "new money" investments contribute to raising the current earnings rate which determines the amount of the exclusion with respect to older pension contracts.

[15] This fifth category of "interest paid" was added by TEFRA together with certain other changes in the taxation of policyholders of annuity contracts. Generally, this provision allows a full deduction (92½ percent for mutual companies) for all interest credited to deferred annuity contracts if the rate of interest is guaranteed in advance for not less than 12 months.

into account in computing the policyholders' share of investment yield. Because the life insurance company's share of the interest paid on the mortgage to the partnership is taken into account in determining the proportion of each item of investment yield allocable to the policyholder, while at the same time lack of direct offset can contribute to a higher adjusted reserves rate, a greater than a dollar-for-dollar offset of the interest income from the loan to the partnership can result.

(3) Revaluation of life insurance reserves computed on a preliminary term basis (Sec. 818(c))

Under a system of taxation that provides for the exclusion of income (the policyholders' share of investment yield) that is computed as a percentage rate times a base amount, the method for fixing the base amount to be used becomes very important. As the policyholders' share of investment yield is computed by multiplying certain statutory reserves by an earnings rate, the method used for computing such reserves will have substantial impact on the amount of Federal taxes to be paid by companies.

As is indicated in the discussion of State regulation, a life insurance company is generally allowed to choose between two methods of computing its reserve required by State law—the net level premium method or a preliminary term method. As was pointed out in that discussion, reserves computed on a net level basis are generally higher, both initially and throughout the life of the contract, than reserves computed on a preliminary term basis. In order to avoid an unfair tax penalty against companies who had chosen to compute their State law reserves on a preliminary term basis for financial reasons, the 1959 Act and present law allow life insurance companies to revalue life insurance reserves computed on a preliminary term basis to net level premium reserves for tax purposes (other than for purposes of qualification). They may do so by using an exact revaluation or an approximate revaluation under a formula provided in the Code.

Under the 1959 Act, the approximate revaluation formula provided that preliminary terms reserves could be revalued by increasing such reserves by $21 per $1,000 of insurance in force for other than term insurance, less 2.1 percent of the reserves under such contracts, and could be increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula was presumably adopted to aid small insurance companies that could not afford exact revaluation because of lack of computer facilities. Although intended to aid small companies, use of the approximate revaluation formula is not limited to companies of a certain size.

The approximate revalution formula may have been accurate when it was adopted, but with changes in mortality and interest rates and methods of computing preliminary term reserves, application of the approximate revaluation formula often results in an amount of reserves greater than possible using an exact revaluation method. A lack of any computer facilities in even small life insurance companies no longer is true and, because the use of the

approximate revaluation formula is not statutorily limited to small life insurance companies, its general use by all life insurance companies in order to reduce their tax liability can represent a large Federal tax revenue loss. Taking these factors into consideration, TEFRA permanently reduced the amount of increase to be allowed for insurance other than term insurance from $21 to $19 for contracts issued after March 31, 1982. This change reduced, but did not eliminate, the tax-saving which can be enjoyed by life insurance companies using the approximate revaluation formula.

In addition to questioning whether an approximate revaluation formula should be allowed, one might question whether revaluation of preliminary term reserves should be allowed at all. When the 1959 Act was adopted, about half the industry computed statutory reserves on a net level premium basis, while the other fims used a preliminary term basis. Thus, the argument that revaluation would prevent inequitable tax treatment appears to have been valid, however, today, most companies are using a preliminary term basis for purposes of computing reserves with respect to newly issued contracts. The inequity with respect to statutory reserves no longer exists. In addition, the estimation of net level premium reserves assumes that expenses are amortized over the life of the contract, while such expenses historically have been deducted in the first year, may lead one to question whether use of net level premium reserves should continue to be permitted for tax purposes of whether amortization of commissions should be required.

(4) Deduction for small business, tax-exempt income and dividends received (sec. 804)

In computing taxable investment income, the amount of the company's share of investment yield and any net capital gain is reduced by a small business deduction and the company's share of tax-exempt income and the dividends-received deduction. The small business deduction which was generally intended to aid smaller life insurance companies is allowed for all companies regardless of asset size. That deduction is equal to 10 percent of the investment yield of the company for the taxable year up to a maximum of $25,000.

Also, the 1959 Act requires that the company, in determining the policyholder's share of investment yield, allocate each and every item of investment yield (including tax-exempt income and intercorporate dividends received) between the policyholders and the company. Thus, this allocation rule, in effect, requires a company to use, in part, its tax-exempt income and intercorporate dividends to meet its liabilities to policyholders. Because it allows a company to use only a portion of its tax-exempt income and intercorporate dividends received for its own benefit, the allocation rule prevents a life insurance company from investing in a calculable amount of such income-producing properties to shelter the company's taxable income and avoid paying any tax. The same allocation rule is not applicable to other financial intermediaries such as banks, savings and loans, or nonlife insurance companies.

b. Gain and loss from operations (sec. 809)

The second potential part of the company's tax base is one-half of the excess of any gain from operations over taxable investment income. The computation of gain and loss from operations includes gross receipts from all sources less all related expenses. For this purpose, gross receipts takes into account not only the company's share of investment yield [16] and net capital gains included under the first part, but also premiums and other consideration, decreases in certain reserves, and all other amounts not already included.[17] Deductions are allowed against these gross receipts for the amounts paid as claims and benefits, for operations loss carrybacks and carryover for amounts paid in connection with assumption reinsurance, for the company's allocable share of tax-exempt income or intercorporate dividends received, for small business deductions, for all deductions allowed other taxpayers [18] (including investment expenses not allowed in computing investment yield), and also for increases in life insurance and other reserves required by State law.

In addition, three special deductions are allowed. First, in the case of participating policies, a deduction is allowed for dividend payments or rate credits to policyholders. Presumably, the payment of policyholder dividends reflects the fact that mutual insurance may be written on a higher initial premium basis than nonparticipating insurance. The amounts returned as policyholder dividends can be considered, in part, a return of redundant premium charges which provide a cushion for mutual insurance companies for meeting various contingencies. They may also be, in part, investment earnings on the redundant premium charges. To have funds equivalent to a mutual company's redundant premiums, a stock company must maintain relatively larger surplus and capital accounts, and generally the surplus must be funded out of taxable income of the company. To compensate for this, a second special deduction is allowed for nonparticipating insurance issued.[19] The policyholder dividend deduction and the deduction for nonparticipating insurance, together with their respective limitations, address a special problem presented in the case of life insurance companies, that is, that life insurance is sold by both mutual companies and stock companies. The treatment accorded policyholder

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[16] For purposes of the second part of the company's tax base, the company's share of investment yield is determined based on the company's actual contractual interest assumptions for additions to reserves rather than by the application of the Menge formula.

[17] The gross amount of underwriting income includes all premiums and other consideration, such as advance premiums, deposits, fees, assessments, consideration for assumption reinsurance, and policyholder dividends reimbursements received under reinsurance agreements; these amounts are adjusted for return premiums and premiums and other consideration arising out of reinsurance ceded. Also added into gross underwriting income are any decreases in reserves and all amounts not included in computing investment yield or not otherwise includible in computing the gross amount of underwriting income.

[18] Specifically, in computing the gain or loss from operations, a life insurance company is allowed all other deductions, otherwise allowed for computing taxable income, subject to certain modifications. For example, any deduction for interest may not include the amount allowed for qualified guaranteed interest or for interest in respect of reserves. Life insurance companies are not allowed a reserve for bad debts, and there are special rules for computing the amount of charitable deductions allowed a life insurance company, for amortization of bond premiums, for net operating loss deductions, and for the dividends received deductions.

[19] This special deduction is 10 percent of the annual increase in reserves for nonparticipating contracts of 3 percent of the premiums for the taxable year for nonparticipating contracts (other than group contracts) that are issued or renewed for 5 years of more.

dividends, with the limitation on their deduction, accounts in large part for the relative distribution of tax burden between mutual and stock companies. Finally, a third special deduction is allowed for accident and health insurance and group life insurance contracts.[20] This special deduction may be viewed as recognizing a contingency reserve for these contracts which arguably compensates for the fact that in group insurance there is less than the usual diversification of risk and therefore a higher probability of financial loss for the company. Such a contingency reserve may or may not be required by State law.

As a practical matter, because mutual companies pay policyholder dividends (which uses up the limitation on the special deductions), this special deduction for group insurance is also a factor, which works in favor of stock companies in dividing the tax burden of the industry.

Under the 1959 Act and present law, none of the three special deductions is allowed to reduce taxable investment income beyond a certain limited amount, or to create a net operations loss that can be carried over and applied to reduce an underwriting gain in another year. In addition, stock life insurance companies are required to carry the amount allowed for nonparticipating contracts and for accident and health and group life insurance contracts in a deferred tax account (the policyholders' surplus account), because such amounts do not represent actual expenditures for the company.

The amount obtained after subtracting the various deductions from gross receipts is known as gain (or loss) from operations. If the result is a gain from operations, computation of the second part of the company's tax base requires the subtracting of taxable investment income as computed under the first part, because this amount would already be included in the tax base. The amount remaining can be described as an underwriting gain, because it consists in large part of mortality and loading savings. The mortality savings are those resulting from the fact that deaths have occurred at a rate less than that assumed in establishing the life insurance premiums and reserves. Loading savings are attributable to the fact that actual expenses are lower than those estimated for placing policies on the books and servicing them from that time on. In addition, this underwriting gain may also include minor amounts of investment income because, under the second part of the tax base computation, the exclusions allowed for earnings credited to reserves is based on the company's contractual interest assumptions, while under the first part the exclusion of the policyholders' share of investment yield (by operation of the Menge formula) assumes that certain higher proportions of investment income are required for reserves. Having determined an underwriting gain, one-half of this amount is added to the taxable investment income as the second part of the company's tax base. The half of the underwriting gain that is not part of the company's current tax base is

[20] The deduction for accident and health and group life insurance contracts is 2 percent of the premium income from such insurance for the taxable year, the aggregate for all taxable years not to exceed 50 percent of the premium income for the current taxable year.

added to a deferred tax account called the policyholders' surplus account. (sec. 815(c)(2)(A))

If there is an underwriting loss (that is, either the gain from operations is smaller than taxable investment income or there is a loss from operations), the tax treatment is somewhat different from that earlier described. In such a case, the total tax base is the gain (or loss) from operations. An underwriting loss is allowed in full to offset taxable investment income. This was intended to aid new and growing companies with high administrative and acquisition costs for new contracts.

(1) Company's share of investment yield (sec. 809(a))

Before determining the gross amount of income for purposes of computing gain or loss from operations, the insurance company is allowed to exclude the share of investment yield set aside for policyholders. However, rather than applying the Menge formula as was done in computing the policyholders' share of investment yield under taxable investment income computations, in this instance (except for pension plan contracts) the policyholders' share is computed as that portion of each item of investment yield which bears the same ratio as required interest to the entire investment yield. Required interest is computed as the sum of the amount of any qualified guaranteed interest and the amount of earnings contractually guaranteed to the policyholders based on each rate of interest required or assumed by the company in calculating the reserves for the policies. By referring to required interest, the policyholders' share of investment yield in computing gain from operations is generally smaller than under the taxable investment income computation with the result that a larger amount of investment yield is included in computing gain from operations. Thus, by comparing taxable investment income with gain from operations, the limitation on policyholder dividends under the 1959 Act allowed the distribution of some amount of investment income to policyholders over and above the amount contractually required and the statutory dollar amount.

(2) Increases and decreases in reserves

Under present law, increases and decreases in reserves are recognized either as deductions or as income. For purposes of computing the amount of each, year-end reserves are adjusted to not include the policyholders' share of investment yield for the taxable year (which was not included in gross income for purposes of computing gain or loss from operations). The reserves taken into account for purposes of increases and decreases are (1) life insurance reserves, (2) the unearned premiums and unpaid losses included in total reserves, (3) the amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts, but only if such obligations do not involve (at the time with respect to which the reserve is computed) life, health, and accident contingencies, (4) dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts, (5) premiums received in advance, and liabilities for premium deposit funds, and (6) certain special contingency

reserves under contracts of group term life insurance or group health and accident insurance.

(3) Limitation on special deductions (sec. 809(f))

Specifically, the 1959 Act limited the amount of the deduction for policyholder dividends, nonparticipating contracts, and accident and health and group life contracts to the excess of gain from operations (if any) over taxable investment income, plus $250,000. The combined limitation applied first to the amount of the deduction for policyholder dividends, then to the amount for accident and health and group life insurance contracts, and finally to the amount for nonparticipating contracts.

However, under TEFRA, for taxable years 1982 and 1983, there are two alternative means of calculating the limitation: either (1) the prior limitation with the statutory dollar amount increased from $250,000 to $1 million; or (2) if the taxpayer so elects, a limitation equal to the sum of (a) 100 percent of policyholders dividends allocable to insured qualified pension plans, (b) a statutory amount of $1 million, and (c) in the case of a mutual company, 77½ percent of the amount of policyholder dividends paid on other than qualified pension business or, in the case of a stock company, 85 percent of the sum of such policyholder dividends and the special deduction for nonparticipating contracts. To restore the value of the minimum statutory dollar amount as an aid to small life insurance companies, the amount was increased to reflect the affects of inflation. However, the statutory dollar amount is (though only temporarily) more closely targeted toward smaller companies; the amount is phased down when the sum of the policyholder dividends and other tentative special deductions exceeds $4 million and totally eliminated when that sum equals or exceeds $8 million. In general, the percentage limitation on the deduction for policyholder dividends and nonparticipating contracts currently has the practical effect of allowing a larger percentage of such amounts to be deducted than would otherwise be deductible under the limitation adopted under the 1959 Act, which was designed to prevent the distribution of free investment income without tax at the company level.

With respect to the alternative percentage limitation temporarily available for policyholder dividends paid on other than qualified pension business and the deduction for nonparticipating contracts, the 7½-percent differential between mutual companies and stock companies (which might be called a "profit differential") was intended to reflect the fact that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them as owners of the company and, accordingly, should not be deductible.[21]

Finally, as another temporary provision, the statutory dollar amount of the limitation, as applied to an affiliated group of corporations, is to be divided equally among the companies which are component members of the group on December 31 of each taxable

[21] A similar percentage differential is contained in the deduction allowed for qualified interest credited by life insurance companies on annuity contracts (100 percent on nonparticipating contracts and 92½ percent on participating contracts).

year unless Treasury regulations are prescribed to permit an unequal allocation. This provision together with a provision to target the statutory dollar amount for small companies raises the unresolved question of whether the phasing-down procedure should be applied to the affiliated group as a whole or to the individual companies' allocable share of the statutory dollar amount.

(4) Policyholder dividends

Under present law, policyholder dividends are defined to mean dividends and similar distributions to policyholders in their capacity as such; the term does not include interest paid (sec. 811(a)) (see the discussion of what constitutes interest paid in Part IV. B.2.a(2) of this pamphlet). The Treasury regulations further provide that the term includes amounts returned to the policyholder that are not fixed in the contract, but depend on the experience of the company or the discretion of the management. Subject to the limitation discussed above, life insurance companies are allowed to compute the amount of the policyholder dividend deduction on an accrual basis.

Under the 1959 Act, a limitation was placed on policyholder dividends in order to limit the ability of mutual companies to reduce their taxable income to zero (the limitation adopted preserved substantially the tax base under prior law and maintained the level of company tax being paid). In a broader sense, the purpose underlying the limitation on policyholder dividends might be viewed as being to limit the ability of companies to distribute investment earnings in excess of the required policyholders' share (that is, to limit the ability of companies to distribute investment earnings that would otherwise be taxable to the company) without any tax at the company level. Thus, the limitation could be viewed as prescribing, in effect, a minimum tax on net investment income.

In recent years, new product developments have raised the question of the scope of the definition of policyholder dividends and the application of the limitation. Specifically, the Internal Revenue Service has concluded in private ruling letters that interest credited in excess of the rate guaranteed for the life of the contract, and indeterminant premium adjustments, are policyholder dividends and not additional benefits under the policy or valid price adjustments.

Arguably, the guaranteed character of excess interest and the contractual adjustment for a reduction of future premiums cause such items to literally and technically fall outside the statutory definition of policyholder dividends. On the other hand, one can argue that excess interest and indeterminant premium adjustments are policyholder dividends because they are not fixed (because the guarantee changes from time to time) and the amount guaranteed depends on management's judgment on a company's anticipated experience. In any case, what might be considered a rather academic legal argument raises a practical economic issue within the life insurance industry. Are policyholder dividends, excess interest and indeterminant premium adjustments economic equivalents? If so, should the definition of "policyholder dividends" (and the limitation on the deduction thereof) be broadened to in-

clude any distributions to policyholders of earnings that are in excess of those guaranteed for the life of the contract?

(5) Deduction for nonparticipating contracts

As was discussed earlier, companies that issue nonparticipating contracts are allowed a special deduction (based on either the increase in the reserves or the amount of premiums received for certain nonparticipating contracts for the taxable year) because such contracts are priced with a smaller margin for profit than participating contracts, which use policyholder dividends as a vehicle of returning any overcharges. As a practical matter, because the deduction does not represent an actual expenditure, the deduction shelters income from tax and increases the surplus available for the general use of the company or for meeting unforseen liabilities.

Theoretically, if the deduction recognizes a contingency reserve because nonparticipating contracts may carry higher risk of financial loss, then the contingent reserve with respect to such nonparticipating contracts should be recovered when the company eliminates this higher risk of loss through reinsurance. However, the provision in the current law that allows the deduction for nonparticipating contracts does not specifically require that an adjustment be made to recapture the benefit of a previous deduction for nonparticipating contracts when the risks underlying such contracts are reinsured with another insurance company. The lack of adjustment arises, in part, from the deduction allowance being defined as the greater of two alternative limitations, without restriction on which can be used in any one year.

Also, when risks assumed under nonparticipating contracts are coinsured with another insurer, the second insurance company is allowed a deduction for the same nonparticipating contracts. A question can arise, however, as to whether risks initially insured under participating contracts can be reinsured under contracts that are "nonparticipating" to allow a reinsurer to claim the special deduction.

(6) Deduction for accident and health insurance and group life insurance

Like the deduction for nonparticipating contracts, the present deduction for accident and health insurance and group life insurance helps define the balance regarding the tax burden borne by the different segments of the industry and increases the amount of surplus available for use by the company. Beyond these reasons for the special deduction, the question arises whether the accident and health insurance and group life insurance business has any particular characteristic that would justify special tax treatment. For example, would recognition of a contingency reserve for this sort of business be justifiable given the industry's loss experience in this area over the past years? Likewise, an argument might be made that there should be some special treatment for accident and health insurance and group life insurance because, as with contracts for insured pension plans, the industry's competition for such business is generally tax-exempt under the Code (e.g., Blue Cross-Blue Shield, and sec. 501(c)(9) insurance trusts). These group insurance contracts generally call for experience-rated refunds

which allow the purchaser to share in the favorable experience of the group while at the same time having the insurance protection against unfavorable experience of losses within the group. If the legislative policy adopted is that the insurance industry should be allowed to compete freely with their tax-exempt counterparts, then arguably a full deduction should be allowed for any amounts credited to group insurance contracts or any experience-rated refunds paid to purchasers of such contracts.

c. Additions to and subtractions from the policyholders' surplus account

As previously indicated, if there is an underwriting gain, only one-half is taxed currently in the second part of the insurance company's tax base, while the other half is added to a deferred tax account called the policyholders' surplus account. The deferral was allowed because it was thought to be too difficult to establish with certainty the actual annual underwriting income of life insurance companies, given the long-term nature of life insurance contracts. Arguably, amounts that appeared to be income in the current year and proper additions to surplus would, as the result of subsequent events, be needed to fulfill obligations under life insurance contracts. Thus, present law does not attempt to tax on an annual basis all of what appears to be income. Also, as with the treatment of policyholder dividends, the deferral of taxes on half the underwriting gain of life insurance companies has contributed to the relative tax burden borne by segments of the industry.

When a company distributes dividends to shareholders that are in excess of the previously taxed investment and underwriting income, the company itself has made a determination that additional amounts constitute income not required to be retained to fulfill the policy obligations. Therefore, the third potential part of a life insurance company's tax base includes income distributed by the company to shareholders in excess of amounts already taxed on a current basis at the time of the distribution. This previously untaxed amount also is included in the life insurance company's tax base if the cumulative tax-deferred amount exceeds certain percentages of reserves or current premium income,[22] or if the company ceases to be a life insurance company. Aside from certain planned instances in connection with mergers and acquisition of life insurance companies, distributions from policyholders' surplus accounts are rare.

(1) Distributions to shareholders (sec. 815)

Generally, any distribution to shareholders is treated as made first out of the shareholders' surplus account (to the extent thereof),[23] then out of the policyholders' surplus account (to the extent

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[22] The half of the underwriting income not taxed currently is taxed if the cumulative amount (the policyholder surplus account) exceeds the greatest of 15 percent of life insurance reserves the end of the taxable year, 25 percent of the amount by which the life insurance reserves exceed those held at the end of 1958, or 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under the gain (or loss) from operations computation.

[23] The amount added to the shareholders' surplus account for any taxable year is the amount by which the sum of, (1) the life insurance company taxable income (computed without regard to

Continued

thereof), and finally out of other accounts. Distributions from the policyholders' surplus account are taxed in the year distributed (that tax is referred to as a phase 3 tax). Each stock life insurance company must establish and maintain a policyholders' surplus account (the amount in such account was zero as of January 1, 1959.)[24] The amount added to the policyholders' surplus account for any taxable year is the sum of (1) 50 percent of the excess of the gain from operations over the taxable investment income, (2) the deduction for certain nonparticipating contracts (as limited), and (3) the deduction for accident and health insurance and group life insurance contracts (as limited). If distributions to shareholders are treated as made from the policyholders' surplus account, then the company subtracts from the policyholders' surplus account for that year an amount equal to the distribution plus the tax attributable to the distribution.[25]

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any phase 3 tax), (2) the amount (if any) of the net capital gain reduced by the amount of life insurance company taxable income, (3) the company's share of tax-exempt interest and dividends received, and, (4) the small business deduction exceeds the taxes imposed for the taxable year (determined without regard to any phase 3 tax).

[24] It should be noted that only stock life insurance companies are statutorily required to maintain the policyholders' surplus account because, as a practical matter, mutual life insurance companies offset any potential underwriting gain with the payment of policyholder dividends.

[25] There is a special rule for correcting erroneous distributions from a policyholders' surplus account, if the amounts so distributed are returned by the company to the policyholders' surplus account before the time prescribed for filing the tax return for the taxable year in which the distribution was made.

C. International Taxation of Insurance Companies

1. Foreign income of U.S. companies

Foreign tax credit

General rules

Life insurance companies are generally subject to the same rules governing foreign income as other U.S. corporations. The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country ("foreign tax credit").

A credit is available only for foreign taxes that are income taxes under U.S. concepts and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government. Certain taxes on gross premiums of U.S. taxpayers engaged in the life insurance business in a foreign country are creditable "in lieu of " taxes (Rev. Rul. 74-311; Rev. Rul. 72-84). Certain taxes paid by foreign subsidiaries of U.S. corporations are creditable when the U.S. corporation receives a dividend or a deemed dividend from the foreign subsidiary.

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. The limitation uses a ratio of foreign source taxable income to total worldwide taxable income. This ratio is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes that, absent a foreign tax credit, would be paid on the foreign income and, thus, the upper limit on the foreign tax credit.

The foreign tax credit limitation and the phases of taxation for life companies

The three-phase formula for calculation of life insurance taxable income makes calculation of foreign tax credit limitation for U.S. life companies complicated. The Internal Revenue Service has taken the position in a private letter ruling that the numerator of the foreign tax credit limitation fraction (foreign source income) encompasses a foreign source income on a phase-by-phase basis.[26] If so, a company paying relatively high creditable income taxes or in-lieu-of taxes on foreign source underwriting income may have an incentive to generate foreign source investment income by investing abroad rather than in the United States.

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[26] See Letter Ruling 6806281280A. For a Phase I company, only investment income would enter into the calculation.

Separate limitation for interest income

Most U.S. taxpayers are subject to a separate foreign tax credit limitation for certain interest income. Interest derived in the conduct by the taxpayer of a banking, financing, or similar business is excluded from the separate limitation. Legislative history has made it clear that the insurance business is a "similar" business. H. Rep. No. 1450, 89th Cong., 2d Sess., 39 (1966); S. Rep. No. 1707. 89th Cong., 2nd Sess., 46 (1966). The absence of a separate limitation for interest derived in the insurance business could allow credits for foreign income taxes imposed on interest income to reduce U.S. tax on other classes of foreign income. Likewise, foreign taxes on other foreign income, such as foreign underwriting income or dividend income, could reduce U.S. tax on interest income.

Source of underwriting income

A U.S. company may prefer foreign source to U.S. source underwriting income, because such foreign source income may allow the company to increase its foreign tax credit limitation and thus to reduce its U.S. tax burden. If a U.S. company bases its calculation of the limitation on only investment income, however, it will have little or no preference for having underwriting income have a foreign source.

The Internal Revenue Service takes the position that the source of life insurance company underwriting income is the residence of the insured (Intenal Revenue Manual, Part IV (Audit) at 4232.1, ch. 253.7(3)). Some [27] argue, however, that the statute does not specify a rule for life company underwriting income. Under their view, the source is the place of contract, which was arguably the source of underwriting income from all insurance contracts until Congress provided a location-of-the-risk rule for only nonlife policies in 1976. Under the place of contract rule, concluding a contract for the reinsurance of U.S. lives in a foreign country makes the income from that contract foreign source. Such a source rule could allow companies with excess foreign tax credits to reduce their U.S. taxes by generating foreign source income.

Contiguous country business

A U.S. mutual life insurance company may generally elect to exempt the income of its branches that operate in Canada or Mexico. Such branches generally derive their income from the issuance of policies on local risks and from investment income from reserves on local risks. Under the principle of mutuality, this income inures solely to the benefit of local policyholders. Congress therefore exempted that income from U.S. tax so long as the foreign branch does not repatriate it to the United States.

2. Foreign life insurance companies

Foreign corporations in general

Foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States.

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[27] *See* Tucker and Van Mieghem, *Federal Taxation of Insurance Companies 1982*, at 25.04.

The United States generally imposes a flat 30-percent tax on the gross amount of U.S. source investment income (and certain other U.S. source income) paid to foreign persons when that income is not effectively connected with a U.S. trade or business. The tax on gross amounts of interest, dividends, and royalties may be reduced or eliminated under bilateral income tax treaties.

A foreign corporation that is engaged in a U.S. trade or business is taxable on its U.S. source income that is effectively connected with the conduct of its U.S. trade or business. It is subject to the flat 30-percent or lower treaty rate on the gross amount of investment income not effectively connected with its business. It is subject to the graduated corporate tax on all its other U.S. source income, whether or not that income is effectively connected with the U.S. trade or business in which it engages, and on foreign source income that is effectively connected with the conduct of its U.S. trade or business. Whether a foreign corporation is engaged in a U.S. business is largely a question of fact.

Taxation of foreign life insurance companies in general

A foreign corporation carrying on an insurance business within the United States that would qualify as a life insurance company if it were a U.S. corporation is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

Effectively connected income of a foreign corporation carrying on an insurance business within the United States includes all income (such as investment income attributable to required reserves) from foreign sources that is attributable to the U.S. business.[28] Such a foreign corporation is taxable at the 30 percent or lower treaty rate on its U.S. source investment income that is not effectively connected with a U.S. trade or business.

A foreign life insurance company that is engaged in a U.S. trade or business is taxable on U.S. source underwriting income but not on foreign source underwriting income (unless that foreign source underwriting income is effectively connected with a U.S. trade or business). If, as suggested in the discussion of the source of underwriting income for U.S. companies, the source is the place of contract, foreign life insurance companies may have flexibility to earn underwriting income from reinsuring U.S. risks without U.S. income tax liability.

Minimum surplus requirement

A special rule may alter the U.S. tax on foreign life insurance companies doing business in the United States when they hold a relatively small surplus attributable to the U.S. business in the

[28] Some Canadian insurance companies have contended that the U.S.-Canada income tax treaty exempts from U.S. tax passive income they receive from Canadian sources, even when that passive income is effectively connected with and attributable to a U.S. business. The Court of Claims rejected that contention (*Great-West Life Assurance Co.* v. *United States*, 82-1 USTC para. 9374 (1982)). Some Canadian companies may still rely on the argument that Great-West advanced.

United States. This rule applies when the surplus of a foreign life insurance company held in the United States is less than a specified minimum. That minimum amount is the foreign company's total insurance liabilities on U.S. business multiplied by the ratio of the average surplus of domestic corporations to their total liabilities. The Secretary of the Treasury determines this ratio each year.

If the foreign insurance company's surplus held in the United States is less than this minimum amount, then certain deductions of the company decrease. The policy and other contract liability requirements, and the required interest for computing gain from operations, are reduced by the deficiency multiplied by the current earnings rate. An increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business. The reason for reduction in the flat-rate tax is that part of that investment income, in effect, may be income subject to tax under the minimum surplus adjustment.

The Secretary's ratio adjustment may reduce rather than increase the U.S. tax of a foreign corporation if the foreign corporation's tax base is solely gain from operations. The Secretary's ratio adjustment may increase the company's share of tax-exempt interest and deductible dividends received.*

Foreign insurance companies not engaged in U.S. business

Insurance or reinsurance of the life of a U.S. citizen or resident by foreign insurance companies that are not subject to the scheme of taxation described above because they are not engaged in business in the United States is subject to an excise tax at the rate of one cent on each dollar of premium.[29] Certain U.S. income tax treaties, including those with France and the United Kingdom, waive this excise tax in certain circumstances for insurance companies resident in the treaty partner. The U.S. model treaty waives this tax also. Although the model and the French treaty do not waive the tax when the foreign insurer reinsures with a third-country insurer, the treaty with the United Kingdom waives the tax even in that event. Therefore, use of a U.K. conduit company could allow a foreign company from third country to avoid this excise tax by flowing the premiums through a related U.K. company. All taxation can be eliminated if the company to which the premium is paid is located in a tax haven.

In addition, a foreign corporation not engaged in U.S. business is not subject to U.S. tax on foreign source investment income from assets that underlie reserves for U.S. risks.

Gain on dispositon of assests not effectively connected with U.S. business

Foreign corporations are generally subject to tax on dispositions of appreciated property only when that property is effectively con-

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*Ernst & Ernst, *Federal Income Taxes—Life insurance Companies* 385 n.22 (1977); Tucker and Van Mieghem, *Federal Taxation of Insurance Companies 1982* at 25.14.

[29] Such premimums are not subject to 30-percent withholding (Rec. Rul. 80-222, 1980-2 C.B. 211).

nected with the conduct of a U.S. trade or business.[30] Foreign life insurance companies often maintain two kinds of investments in the United States: (1) trusteed accounts, consisting of assets necessary under state law to match reserve liabilities, that are effectively connected with the insurer's U.S. business, and (2) nontrusteed accounts, consisting of other investments that are not necessary for or effectively connected with the insurer's U.S. business. States generally allow companies freely to remove assets from trusteed accounts and to substitute assets of equivalent value.

In audits, the Internal Revenue Service has at times taken the position that the basis of assets in trusteed accounts is the value at date of acquisition rather than the value at date of transfer into the account. Some foreign life insurance companies may be taking the position that they may transfer appreciated assets from trusteed accounts to nontrusteed accounts free of U.S. tax. This result would enable these foreign life insurance companies to avoid U.S. capital gains tax, and would give them an advantage over U.S. competitors.

Controlled foreign corporations insuring U.S. risks

U.S. shareholders

The foreign source income of a foreign corporation that is not effectively connected with a U.S. business is generally subject to U.S. income tax only if and when it is actually remitted to U.S. shareholders as a dividend. However, under the subpart F provisions of the Code, income from certain tax haven type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them (subject to the foreign tax credit). The income taxed under Subpart F generally includes investment income such as dividends and interest, and income from the insurance of U.S. risks.[31] This rule prevents U.S. insurers from shifting underwriting income to tax-haven subsidiaries. Income from assets that underlie reserves on U.S. risks is also currently taxable to the U.S. shareholders of a controlled foreign corporation.

If a U.S. corporation controlled by foreign shareholders reinsures risks with a related foreign party, no analogous rule applies. The Code requires, however, that the U.S. party to such a transaction pay an arm's-length price for such reinsurance.

Captive insurers

A captive insurance company is generally one that insure risks of related parties. In several tax plans, companies pay insurance premiums (directly or indirectly) to captive foreign insurance subsidiaries. The Internal Revenue Service has denied deductions for such payments on the ground that the payments represent nondeductible self-insurance (Rev. Rul. 77-316). The courts have support-

[30] Dispositions of appreciated U.S. real property interests are generally subject to tax notwithstanding this rule (sec. 897).

[31] A special rule for insurance income expands the definition of controlled foreign corporation for Subpart F purposes to include certain foreign corporations of which more than 25 percent (rather than the standard 50 percent) of the total combined voting power of all classes of stock is owned by U.S. shareholders if more than 75 percent of gross premiums are attributable to U.S. risks.

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ed this view (*see Carnation Co.* v. *Commissioner,* 71 T.C. 400 (1978), *aff'd,* 640 F.2d 1010 (9th Cir, 1981)).

Such captive insurance plans take several forms. In one plan, the U.S. company attempts to generate foreign source income (and thus to increase the foreign tax credit limitation and to reduce U.S. taxes). For instance, a U.S. company may buy insurance from an unrelated party that promises to reinsure the risk with the offshore captive of the insured U.S. company. The U.S. company deducts the premium from its U.S. income. The captive foreign insurer may generate Subpart F income (from the insurance of U.S. risks) that is currently taxable to the U.S. parent (the insured). That Subpart F income, however, may be foreign source income that allows the taxpayer to credit other foreign taxes.

Another variant of the captive insurance technique is to insure foreign risks with the captive insurance subsidiary. In this case, the captive company's income is not subject to Subpart F inclusion in the income of its U.S. parent because the income does not arise from insuring U.S. risks.

Despite administrative and judicial rejection of the captive technique, the insurance markets "in places such as Bermuda and the Cayman Islands . . . are increasingly being used by life companies for reinsurance," and "life companies that are considering the formation of a subsidiary for purposes of reinsurance . . . view these markets as a potential situs for the affiliate." [32] In addition, local laws in those jurisdictions "also seem to be desirable to noninsurance companies forming their own captive life insurance companies. Examples are finance companies, savings institution, or auto dealers wanting to insure credit-life risks previously placed with unrelated companies." [33] It is unclear to what extent tax reasons may motivate formation of captive life insurance companies.

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[32] Tucker and Van Mieghem, *Federal Taxation of Insurance Companies 1982,* at 25.01.
[33] *Id.*

D. State Taxation

The principal method the States have of taxing life insurers is through a premium tax, levied against the premiums charged.[34] Premium tax rates range from 1 to 4 percent, with 2 percent being the most common. Also, some states reduce the tax if assets of the insurer are invested in the State. States also differ as to what items are included in the tax base: in some States the tax is applied against all premiums, while in others certain types of premiums (i.e., annuities) are not taxed or are taxed at a lower rate. Another variable is the deductibility of policyholder dividends from the premium base. Finally, in most States, the premium tax is in lieu of any income taxes, although in some the State income tax is treated as an offset to the premium tax.

[34] The United States imposes a premiums excise tax of 1 percent on premiums paid to certain foreign insurance companies for life insurance, sickness and accident policies, annuity contracts, and for reinsurance of such policies. [Sec. 4371]

V. STATISTICAL MATERIAL RELATING TO LIFE INSURANCE INDUSTRY

A. Selected Life Insurance Statistics

In Table 1, selected statistical data, from the following tables, have been grouped to provide some comparisons about activities in the industry.

The first three columns show two sources of life insurance company income and a primary cause for payments. The relative reduction in life policy benefit payments compared with the sum of life insurance premium income and investment income, from 35 percent in 1970 to 27 percent in 1981, reflects various changes that have occurred in the nature of the life insurance business, and probably, investment income must be applied to cover costs incurred in other than life insurance business.

Comparison of the fourth and fifth columns reflects a steady decrease in the ratio of life insurance policy reserves to the amount of life insurance in force. By 1981, the historical trend shows the reserves as 5.1 percent of the amounts of life insurance in force. The lower ratio reflects, at least, more sophisticated procedures for estimating the amount of reserves that must be held in order to meet policy contingencies. The computation of how much reserves necessarily should be held follows statutory standards imposed by State government insurance commissioners; the required computation is a conservative one that is designed to assure that sufficient funds will be on hand to meet obligations as they arise.

Table 1.—Summary Statistics Relating to Life Insurance, 1945–81

[Millions of dollars]

Year	Life insurance premium income	Investment income	Life policy benefit payments [1]	Life insurance policy reserves	Life insurance in force [3]	Funds for policyholder dividend payments [4]
1945	4,589	1,445	1,985	[2] 38,667	151,762	
1950	6,249	2,075	2,777	[2] 54,946	234,168	(5)
1955	8,903	2,801	3,861	54,588	372,332	(5)
1960	11,998	4,304	5,776	70,791	586,448	1,201
1965	16,083	6,778	7,858	90,795	900,554	1,780
1970	21,679	10,144	11,115	115,442	1,402,123	2,647
1975	29,336	16,488	14,327	150,063	2,139,571	3,540
1976	31,358	18,758	15,175	158,359	2,343,063	4,875
1977	33,765	21,713	15,932	167,281	2,582,815	5,252
1978	36,592	25,294	17,077	177,743	2,870,250	5,839
1979	39,083	29,562	18,706	188,177	3,222,340	6,380
1980	40,829	33,928	21,062	197,865	3,541,038	7,158
1981	47,356	39,773	23,625	206,986	4,063,595	7,659
						8,355

[1] Includes death payments, matured endowments, disability payments and surrender values under life insurance contracts.
[2] Primarily but not entirely life insurance reserves. Separate details for life insurance and other insurance begins with data for 1955.
[3] Includes amounts of ordinary, group, industrial, and credit life insurance. Credit life insurance purchases are included beginning in 1975 for insurance limited to loans on 10 or fewer years duration.
[4] Funds set aside currently for payment in the next year.
[5] Not available.

Source: American Council of Life Insurance.

B. Assets of Life Insurance Industry

Total asset holdings

Life insurance companies asset holdings, which are shown in Table 2, have increased from $44.8 billion in 1945 to $525.8 billion in 1981. Holdings in each of the seven groups of assets also have increased during the period. The smallest increase was in the government securities group. These holdings decreased almost 50 percent from 1945 to 1955, reflecting the transition from the World War II economy to a more usual government-private sector mix.

In 1945, government securities made up 50 percent of the industry's assets, but holdings of government securities decreased both in absolute amount and in relative importance. The relative decline continued through 1973 and 1974 when governments were 4.5 percent of assets. Since then, governments have increased to 7.5 percent of total assets in 1981.

Fifty largest companies

Mutual life insurance companies dominate the fifty largest life insurance companies. Seven of the eleven largest life insurance companies, i.e., those with more than $10 billion in assets on January 1, 1982, are mutual companies, and mutuals are one-half of the 50 largest life insurance companies, as measured by asset holdings. Table 3 lists the 50 largest life insurance companies; mutuals held $284 billion of the $401 billion asset total for the 50 largest life insurance companies, or 71 percent of the total for this group. The 22 stock companies in this group held 25 percent of the assets, and 3 tax-exempt and fraternal life insurance companies held the remaining 4 percent of assets. As of the date of these asset holdings, the 50 largest life insurance companies held 76 percent of the industry's $526 billion total assets.

Table 2.—Assets of Life Insurance Companies, by Type, 1945–1981

[Millions of dollars]

Year	U.S. Govt Securities	Corporate securities		Mortgages	Real estate	Policy loans	Misc. assets	Total
		Stocks	Bonds					
1945	22,545	10,060	999	6,636	857	1,962	1,738	44,797
1950	16,118	23,248	2,103	16,102	1,445	2,413	2,591	64,020
1955	11,829	35,912	3,633	29,445	2,581	3,290	3,742	90,432
1960	11,815	46,740	4,981	41,771	3,765	5,231	4,273	119,576
1965	11,908	58,244	9,126	60,013	4,681	7,678	7,234	158,884
1970	11,068	73,098	15,420	74,375	6,320	16,064	10,909	207,254
1975	15,177	105,837	28,061	89,167	9,621	24,467	16,974	289,304
1976	20,260	120,666	34,262	91,552	10,476	25,834	18,502	321,552
1977	23,555	137,889	33,763	96,848	11,060	27,556	21,051	351,722
1978	26,552	156,044	35,518	106,167	11,764	30,146	23,733	389,924
1979	29,719	168,990	39,757	118,421	13,007	34,825	27,563	432,282
1980	33,015	179,603	47,366	131,080	15,033	41,411	31,702	479,210
1981	39,502	193,806	47,670	137,747	18,278	48,706	40,094	525,803

Source: American Council of Life Insurance.

Table 3.—Fifty Largest Life Insurance Companies, by Asset Size, January 1982

[Millions of dollars]

Mutuals		Stocks		Fraternals and tax-exempts	
Prudential Life	$62,499	Aetna Life	$25,159	TIAA	$11,439
Metropolitan Life	51,758	Connecticut General	15,103	Lutheran Aid Association	2,515

Equitable Life	36,758
New York Life	21,119
John Hancock	19,937
Northwestern Mutual	12,154
Massachusetts Mutual	10,022
Bankers Life	8,765
New York Mutual	8,389
New England Mutual	7,274
Mutual Benefit	6,619
Connecticut Mutual	5,818
Penn Mutual	3,963
Phoenix Mutual	3,352
Western & Southern	3,210
Pacific Mutual	2,985
National Life	2,576
State Mutual Life	2,552
Manufacturers Life	2,238
Union Mutual Life	2,149
Guardian Life	2,054
Provident Mutual	2,028
Home Life	1,993
Minnesota Mutual	1,933
General American	1,929
Total mutuals	284,074

Travelers	14,803
Lincoln National	5,039
State Farm	3,760
Continental Assurance	3,323
National Life	3,022
Nationwide Life	2,766
Transamerica Occidental	2,603
Franklin Life	2,570
American National	2,520
Great West Life	2,116
IDS Life	2,064
Aetna Life & Annuity	2,036
Variable Annuity Life	2,035
Provident Life	1,951
United of Omaha Life	1,933
Southwestern Life	1,830
Northwestern National	1,714
Liberty National	1,666
Anchor National	1,656
Jefferson Standard	1,645
Total stocks	101,314

Lutheran Brotherhood	1,931
Total others	15,855

Source: American Council of Life Insurance.

Assets, insurance in force, and insurance issued [1]

Seven of the ten largest life insurance companies, as measured by asset size in 1981, were also among the top ten companies in life insurance in force and new insurance issued in 1981. Five of the seven are mutual companies, and the other two are stock companies. The three largest companies, Prudential, Metropolitan Life and Equitable Life—all mutuals—were the top three in the same order in asset size, amount of insurance in force and insurance issued in 1981. The four other companies in the first seven were Aetna Life (a stock company), New York Life, John Hancock and Connecticut General (a stock company).

For the industry as a whole, new life insurance issued in 1981 increased by 29 percent over 1980. The largest 100 companies wrote 68.5 percent of the $960 billion in new insurance.

One-Half of the total $5.6 billion life insurance in force in the United States is on the books of only 25 companies. The three largest companies represent 19 percent of the industry's insurance in force: Prudential, Metropolitan Life and Equitable Life. These three companies and all other mutuals, however, hold only 39 percent of the insurance in force. U.S. stock life insurance companies hold 50 percent of the life insurance in force in the United States.

C. Income of Life Insurance Companies

Life insurance premium receipts have been the single major source of income for life insurance companies since 1945. As shown in Table 4, life insurance premium payments made up about half of total income through 1965. From then through 1981, premium payments for health insurance and annuity considerations and investment income increased at faster rates than life insurance premium payments. The changes reflected increased growth of the health insurance and annuity sectors of the industry. Increased interest rates during the 1970's contributed to the increased investment income.

[1] The information in this section is from *Best's Insurance Management Reports*, June 21, 1982.

Table 4.—Income of Life Insurance Companies, 1945–81

[Millions of dollars]

Year	Premium receipts from			Investment income[1]	Other income	Total income
	Life insurance	Annuity considerations	Health insurance			
1945	4,589	570	.....	1,445	1,070	7,674
1950	6,249	939	1,001	2,075	1,073	11,337
1955	8,903	1,288	2,355	2,801	1,197	16,544
1960	11,998	1,341	4,026	4,304	1,338	23,007
1965	16,083	2,260	6,261	6,778	1,785	33,167
1970	21,679	3,721	11,367	10,144	2,143	49,054
1975	29,336	10,165	19,074	16,448	2,959	78,022
1976	31,358	13,962	21,059	18,758	3,421	88,558
1977	33,765	14,974	23,580	21,713	3,953	97,985
1978	36,592	16,339	25,829	25,294	4,152	108,206
1979	39,083	17,939	27,894	29,562	4,661	119,139
1980	40,829	24,030	29,366	33,928	4,336	132,489
1981	47,356	28,582	31,803	39,773	4,351	151,865

[1] Investment income as defined under accounting rules prescribed for State insurance requirements.

Source: American Council of Life Insurance.

D. Assets and Tax Liabilities

Stock and Mutual Life Insurance Companies

The taxation of life insurance companies blends the distribution of the tax burden between the two dominant types of corporate structures, i.e., stock vs. mutual, with the fundamentally different concepts of operating the business. Stock companies follow traditional private enterprise organizations with shareholders who provide basic capital and expect profits in return. Mutual companies also follow traditional organizational patterns, since mutual assistance societies that provided death and other benefits to groups of individuals who have some characteristic in common go back to the colonial period.

Since 1959, the ratios of tax liability and assets of both sectors to the industry totals have changed considerably. In addition, the changes have shown increasing importance of the stock companies relative to the mutual companies. As shown in Table 5, the stock companies paid 35 percent of the industry's total tax liability in 1959–1961; its relative share of the tax payments fell steadily through 1968 to 30.7 percent, and has increased since then through 1981 to 58.3 percent of the total. Through the same 23-year period, the relative share of assets held by the stock companies has increased steadily from 27.0 percent in 1959 to 42 percent in 1981.

The increase in stock company tax and asset shares over the whole period is fairly close; the tax liability share has increased by 67 percent, and the asset size share has increased by 56 percent. The tax liability share fell after 1961 and did not reach the same relative share until 1977. Both tax liability and assets levels increased throughout the period.

Table 5.—Mutual and Stock Shares of Life Insurance Industry Tax Liabilities and Assets, 1959–81

[Amounts in millions]

Year	Shares of life insurance industry tax liabilities			Assets of life insurance industry		
	Industry tax	Mutual share	Stock share	Industry total	Mutual share	Stock share
1959	556	.650	.350	113,650	.730	.270
1960	529	.650	.350	119,576	.732	.268
1961	577	.650	.350	126,816	.726	.274
1962	614	.670	.330	133,291	.722	.278
1963	657	.670	.330	141,121	.716	.284
1964	687	.675	.325	149,470	.711	.289
1965	727	.675	.325	158,884	.705	.295
1966	809	.666	.334	167,455	.700	.300
1967	912	.699	.321	177,832	.690	.310
1968	1,094	.693	.307	188,636	.680	.320
1969	1,118	.688	.312	197,208	.682	.318
1970	1,183	.689	.311	207,254	.676	.324
1971	1,221	.686	.314	222,102	.669	.331
1972	1,453	.673	.327	239,730	.662	.338
1973	1,651	.665	.335	252,436	.653	.347
1974	1,768	.654	.346	263,349	.648	.352
1975	1,783	.658	.342	289,304	.642	.358
1976	2,000	.655	.345	321,552	.634	.366
1977	2,263	.622	.378	351,722	.624	.376
1978	2,776	.608	.392	389,724	.615	.385
1979	2,975	.600	.400	432,282	.605	.395
1980	2,096	.492	.508	479,210	.596	.404

Table 5.—Mutual and Stock Shares of Life Insurance Industry Tax Liabilities and Assets, 1959–81—Continued

[Amounts in millions]

Year	Shares of life insurance industry tax liabilities			Assets of life insurance industry		
	Industry tax	Mutual share	Stock share	Industry total	Mutual share	Stock share
1981 [1]	1,200	.417	.583	525,803	.579	.421

[1] 1981 tax liability estimated.

Source: American Council of Life Insurance.

E. Life Insurance in Force

Ordinary and group life insurance make up the bulk of life insurance currently in force, as they have done through the period since 1945. By 1981, as shown in Table 6, $4,064 billion in life insurance was in effect. The amount in force continued to increase through the period since 1945.

The predominant form of life insurance has been ordinary life insurance purchased individually directly from life insurance companies. In 1981, $1,978 billion of ordinary life insurance was in force, nearly double the $1,083 billion in force in 1975. Ordinary life insurance consists of term insurance and whole life insurance.

Group life insurance made up $1,889 billion of the total life insurance in force in 1981, more than doubling the $905 billion in force in 1975. Group life insurance is issued in the form of a master policy, under which certificates are issued to the individuals covered.

Table 6.—Amounts and Types of Life Insurance in Force in the United States, Selected Years

[Billions of dollars]

Year	Ordinary	Group	Industrial[1]	Credit	Total
1945	$102	$22	$28	([2])	$152
1950	149	48	33	4	234
1955	217	101	40	14	372
1960	342	176	40	29	586
1965	500	308	40	53	901
1970	735	551	39	77	1,402
1975	1,083	905	39	112	2,140
1976	1,178	1,003	39	124	2,343
1977	1,289	1,115	39	139	2,583
1978	1,425	1,244	38	163	2,870
1979	1,586	1,419	38	179	3,222
1980	1,760	1,579	36	165	3,541
1981	1,978	1,889	35	162	4,064

[1] Industrial life insurance is issued in small amounts, usually less than $1,000, and premiums are payable weekly or monthly.

[2] Less than $500 million.

Source: American Council of Life Insurance.

F. Payments by Life Insurance Companies

Life insurance death benefit payments have been the largest source of payments since 1945, although, as can be seen on Table 7, the relative importance of death benefit payments has declined from about 50 percent ($1.3 billion out of $2.7 billion) in 1945 to less than one-third ($14.2 billion out of $43.5 billion) in 1981.

Payments on surrender values of life insurance ($8.0 billion in 1981) and policy dividends ($7.8 billion in 1981) have increased relatively among payments to policyholders and their beneficiaries. Annuity contract payments have increased at the fastest rate since 1945, and in 1981 were the second largest source of payments at $12.0 billion.

Table 7.—Life Insurance and Annuity Benefit Payments, 1945–81

[Millions of dollars]

Year	Life Insurance Policyholders and Beneficiaries					Annuity payments	Total payments
	Death payments	Matured endowments	Disability payments	Surrender values	Policy dividends		
1945	1,279	407	88	211	466	216	2,667
1950	1,590	495	100	592	627	327	3,731
1955	2,241	614	110	896	1,021	501	5,383
1960	3,346	673	124	1,663	1,512	830	8,118
1965	4,832	931	163	1,932	2,259	1,300	11,417
1970	7,017	978	233	2,887	3,214	2,120	16,449
1975	9,192	946	426	3,763	4,544	3,665	22,536
1976	9,593	976	458	4,148	5,017	4,419	24,611
1977	10,196	932	495	4,309	5,263	5,267	26,462
1978	11,108	916	533	4,520	5,674	5,863	28,614
1979	11,766	913	554	5,473	6,131	7,548	32,042
1980	12,884	908	592	6,678	6,785	10,195	38,042
1981	14,154	883	627	7,961	7,838	12,021	43,484

Source: American Council of Life Insurance.

G. Reserves of Life Insurance Companies

Reserves were $428 billion in 1981, an eleven-fold increase since 1945 when reserves were $38.7 billion. The 1981 reserve level was almost 6 times the 1955 level, as shown in Table 8. Beginning with 1955, industry data provide a breakdown of reserves into categories of reserves. Life insurance reserves predominate at $207 billion, which is 48 percent of the total in 1981 in contrast with 72 percent of reserves in 1955. Group annuity reserves at $160.0 billion in 1981 were 37.6 percent of the reserves; group and individual annuities made up $199.8 billion of the total representing a substantial change in the product activities of the industry.

Table 8.—Life Insurance Company Policy Reserves, 1955–81

[Millions of dollars]

Year	Life insurance	Health insurance	Annuities		Other [1]	Total
			Individual	Group		
1955	54,588	575	(2)	13,216	6,980	75,359
1960	70,791	865	4,327	14,952	7,538	98,473
1965	90,795	1,432	5,028	22,187	8,178	127,620
1970	115,442	3,474	6,951	34,009	7,903	167,779
1975	150,063	6,293	12,442	59,907	8,411	237,116
1976	158,359	6,962	15,347	73,393	8,714	262,775
1977	167,281	8,329	18,932	84,285	9,105	287,932
1978	177,743	9,596	23,057	98,673	9,414	318,483
1979	188,177	10,416	27,103	116,443	9,498	351,637
1980	197,865	11,015	31,543	140,417	9,499	390,339
1981	206,986	11,931	38,800	160,992	9,322	428,031

[1] Other consists of supplementary contracts with and without life contingencies.
[2] Included in group annuities.

Source: American Council of Life Insurance.

APPENDIX

GLOSSARY OF LIFE INSURANCE TERMS

Adjusted reserves rate

The lesser of current or average earnings rates (for the current and preceding four years).

Admitted assets

Assets of an insurer permitted by a State to be taken into account in determining its financial condition.

Amount at risk

Face amount of a policy less accumulated reserves.

Annuity

An annuity contract is a promise by an insurance company to pay the annuitant or a designated beneficiary a specified sum (frequently in installments) for the duration of a designated life or lives in return for a consideration which is often referred to as a premium.

Assumed earnings rate

The weighted average rate of earnings assumed in the calculation of reserves. This is not the rate assumed in calculating premiums.

Cash surrender value

The amount available in cash upon voluntary termination of a policy by its owner before it becomes payable by death or maturity.

Current earnings rate

The amount determined by dividing annual investment yield by the mean of the assets at the beginning and end of the year.

Dividend or policy dividend

A return of part of the premium on participating insurance to reflect the difference between the premium charged and the combination of actual mortality, expense and investment experience. The premium charge is calculated to provide some margin over the anticipated cost of the insurance protection.

Due and deferred premiums

The balance, on December 31, of each year, of premium installments not yet due (deferred) plus premium installments due but uncollected (due).

Endowments

Endowment life insurance, as distinguished from term life or whole-life insurance, pays the face amount of the policy at the time of the insured's death or after a stated number of years, usually 20 to 30 years, whichever occurs first.

Face amount

The amount stated on the face of the policy that will be paid in case of death or at the maturity of the policy. It does not include additional amounts payable under accidental death or other special provisions, or acquired through the application of policy dividends.

Gain from operations

All of a company's receipts (gross income) reduced by the policyholders' exclusion and certain other deductions.

Graded reserves

Reserves which are low initially and increase gradually until they equal net level reserves at 10–20 years.

Inside buildup

That portion of life insurance company earnings which have historically been untaxed, either to the company or the individual policyholder.

Lapsed policy

A policy terminated for nonpayment of premiums.

Level premium life insurance

Life insurance for which the premium remains the same from year to year. The premium is more than the actual cost of protection during the earlier years of the policy and less than the actual cost in the later years. The overpayments in the early years, together with the interest that is earned, serve to balance out the underpayments in the later years.

Life insurance, ordinary

Whole-life insurance written under a contract providing for periodic payment of premiums as long as the insured lives. Life insurance (other than group) usually in amounts of $1,000 or more with premiums paid monthly or at longer intervals.

Matching principle

The accounting principle which dictates that expenses be matched with revenues for any given time period or accounting cycle.

Menge formula

A means of adjusting the mean of life insurance reserves for the current year. The mean reserves are reduced by 10 percent for every 1 percent by which the adjusted reserve rate exceeds the weighted average rate of interest assumed in computing reserves. The life insurance reserves thus adjusted are multiplied by the ad-

justed reserve rate, and the product is added to the product of the mean pension plan reserves times the current earnings rate and to interest paid.

Modified coinsurance

A form of indemnity reinsurance whereby the reinsured maintains the reserves on the policies reinsured and the assets held in relation thereto, and all or a portion of the investment income derived from those assets is paid to the reinsurer as part of the consideration for the reinsurance.

Mortality table

A statistical table showing the death rate at each age, usually expressed as so many per thousand.

Mutualization

The conversion of a stock life insurance company into a mutual life insurance company.

Net level premium

The cost of life insurance based upon pure mortality and interest from the inception of the contract until its maturity date.

Nonforfeiture options

The choices available if the policyholder discontinues premium payments on a policy with a cash value. This, if any, may be taken in cash, as extended term insurance, or as reduced paid-up insurance.

Nonparticipating policy

A life insurance policy in which the company does not distribute to policyholders any part of its surplus. Premiums for nonparticipating policies are usually lower than for comparable participating policies.

Participating policy

A life insurance policy under which the company agrees to distribute to policyholders the part of its surplus which its Board of Directors determines is not needed at the end of the business year. Such a distribution serves to reduce the premium the policyholder had paid.

Policyholders' deduction

The exclusion of the policyholders' share of investment income.

Policyholders' surplus account

The tax-deferred memorandum account maintained by stock companies which consists cumulatively of the deferred amounts of gain from operations and the deductions for nonparticipating policies and group life and accident and health policies.

Policy loan

A loan made by a life insurance company from its general funds to a policyholder on the security of the cash value of a policy.

Policyholder

The person who owns a life insurance policy. This is often the insured, but it may also be a relative of the insured, a partnership or a corporation.

Premium

The payment, or one of the periodic payments, a policyholder agrees to make for an insurance policy.

Reinsurance

An agreement between two or more insurance companies by which the risk of loss is spread so that a disproportionately large loss under a single policy does not fall on one company. Acceptance by an insurer, called a reinsurer, of all or part of the risk of loss of another insurer.

Reinsurance premium

The consideration paid by the ceding company to the reinsurer for the reinsurance afforded by the reinsurer.

Reserve

The amount required to be carried as a liability in the financial statement of the insurer, to provide for future commitments on policies outstanding.

Reserve valuation

The annual valuation of reserves required by the various States to reflect changes in the business on the books of the companies.

Settlement options

The several ways, other than immediate payment in cash, which a policyholder or beneficiary may choose to have policy benefits paid.

Shareholders' surplus account

The tax-paid memorandum account maintained by stock companies against which all distributions to shareholders are charged first. The account is increased cumulatively by taxable investment income and long-term capital gains (to the extent they are excluded from taxable income) and the small business deduction, tax-exempt interest deduction, and dividends received deduction.

Supplementary contract

An agreement between a life insurance company and a policyholder or beneficiary by which the company retains the cash sum payable under an insurance policy and makes payments in accordance with the settlement option chosen.

Taxable investment income

The interest earned, dividends earned, rents and royalties earned of a company less certain deductions (investment expenses, depreciation, real estate taxes and depletion) produces investment yield which is further reduced by the policyholders' share of this yield.

Net long-term capital gains are added to investment yield which is then reduced by the company's share of tax-exempt interest and dividends received and the small business deduction. The remainder is taxable investment income.

Term life insurance

Life insurance protection during a certain number of years, but expiring without policy cash value if the insured survives the stated period.

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Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

ERRATA SHEET FOR JCS-11-83

Page 38, after "$1,000" each place it appears, insert "for other than term".

Page 40, in the second full paragraph, delete the citation to sec. 810(b)(3)(C), and insert at the end of footnote 10 a citation to sec. 805(d).

Page 41, in the carryover paragraph, the citation to sec. 832(c)(11) should appear at the end of the preceding sentence.

Page 48, the last sentence of the first full paragraph should read: "In addition, the fact that the estimation of net level premium reserves assumes that expenses are amortized over the life of the contract, while such expenses historically have been deducted in the first year, may lead one to question whether use of net level premium reserves should continue to be permitted for tax purposes or whether amortization of commissions should be required."